80-1049

No.

Supreme Court, U. S.
FILED
DEC 17 1980
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

WESTERN CATHOLIC CHURCH,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED FOR REVIEW

1. The principal issue is whether the Tax Court and the Court of Appeals erred in determining that the Western Catholic Church was not being "operated" for a religious purpose when its principal activity was accumulating and investing funds in a budding fund for the purpose of constructing a church building, one of the purposes for which it was organized and for which its exemption was initially approved.

2. A secondary issue is whether the Tax Court and the Court of Appeals erred in determining that a part of the "net earnings" of the Western Catholic Church inured to the benefit of a private individual.[1]

[1] The parties to this proceeding in the Court of Appeals were the same as those listed in the caption here.

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

The petitioner Western Catholic Church respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on September 19, 1980.

REPORTS OF OPINIONS

The opinion of the Tax Court below is reported at 73 T.C. 196. The order of the United States Court of Appeals for the Seventh Circuit, which merely adopted the opinion of the Tax Court, is unreported.

GROUNDS FOR JURISDICTION OF UNITED STATES SUPREME COURT

The order of the United States Court of Appeals for the Seventh Circuit, affirming the decision of the Tax Court, was entered September 19, 1980. No petition for rehearing was filed.

This Court has jurisdiction to issue a writ of certiorari in this case pursuant to 28 U.S.C. § 1254.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix. They are:

Section 501, Internal Revenue Code of 1954 (26 U.S.C. § 501).

Section 504, Internal Revenue Code of 1954 (repealed 1969).

Section 511, Internal Revenue Code of 1954 (26 U.S.C. § 511).

Section 512, Internal Revenue Code of 1954 (26 U.S.C. § 512).

Section 513, Internal Revenue Code of 1954 (26 U.S.C. § 513).

Excerpts from Treas. Reg. § 1.501(c)(3)-1 (1959).

STATEMENT OF THE CASE

The Western Catholic Church was incorporated for religious purposes under the Illinois General Not For Profit Corporation Act in 1971. That same year, it applied for and was issued a determination by the Internal Revenue Service that it was exempt from federal income tax under § 501(c)(3) of the Internal Revenue Code. A. 11.

The Internal Revenue Service conducted an audit of the Church's activities for the years 1972, 1973 and 1974. Following this audit, the Church was notified by letter dated April 25, 1978 that the IRS had determined to revoke its tax exempt status, retroactive to April 23, 1971, the date the Church was organized. The grounds for the revocation were that (1) the Church was not, nor had it ever been, "operated exclusively for religious . . . purposes" and (2) a portion of the Church's net earnings had "inured to the benefit of private individuals," both in contravention of I.R.C. § 501(c)(3).

Pursuant to 26 U.S.C. § 7428(a)(1)(A), the Church filed a Petition for Declaratory Judgment in the United States Tax Court, seeking its determination that the IRS had erred in its determination. Following a hearing before a judge of the Tax Court, the Court on October 31, 1979 issued its Order and Decision finding that the Church did not qualify as a § 501(c)(3) organization and sustaining the IRS retroactive revocation of the Church's tax exempt status.

Pursuant to 26 U.S.C. § 7428(a), the Church appealed to the United States Court of Appeals for the Seventh Circuit. In a brief order entered September 19, 1980, the

Court of Appeals affirmed the decision of the Tax Court and adopted its opinion.

The Western Catholic Church was formed and incorporated by S. Dean Slough, his wife Laura, and his daughter, Deana L. Hron. It is located in Quincy, Illinois.

The purpose or purposes for which the Church was organized were set forth in the By-Laws (Ad.Rec.Ex.6-F) and stated in Article V of the Articles of Incorporation as follows:

> To establish a church to embrace persons of all faith, color and creed. To join for a common cause the betterment of man, by helping God in spreading the Gospel. To recruit evangalists, to build, operate and maintain churches, hospitals, nursing homes, schools and to establish missionarys and missions wherever they are needed in the World. We believed the Bible to be the verbally inspired Word of God; the only infallible rule of faith and practice. We believe in the eternal Deity of our Lord Jesus Christ; in his virgin birth; in his substitutionary death on Calvary for our sins; in His bearing of our afflictions and in His bodily reserrection from the grave. We believed in salvation by faith through the shed blood of Jesus Christ. We believe that the true church is composed of all those who have been born again. We believe in the present working and moving of the Holy Spirit in the lives of men, women, children; we believe in carrying out the Great Commission. To evangelize is a vital part of our Christian responsibility. We believe all men are lost apart from the saving grace of Jesus Christ. We believe in the return of Jesus Christ, God's only begotten, Son, to this earth. A.7.

The Articles of Incorporation also provided that the Church, as a means of accomplishing the stated purposes of the organization, had among other powers, the following:

> 3. To borrow money, and, from time to time, to make, accept, endorse, execute and issue bonds, debentures, promissory notes, bills of exchange, and other obligations of the Corporation for moneys borrowed or in payment for property acquired or for any of the other purposes of the Corporation, and to secure the payment of any such obligations . . .
>
> 4. To invest and reinvest its funds in such stock, common or preferred, bonds, debentures, mortgages, or in such other securities and property, real and personal, as it shall deem advisable, subject to the limitations and conditions contained in any bequest, devise, grant or gift, provided such limitation and conditions are not in conflict with the provisions of Section 501(c)(3) of the Internal Revenue Code and applicable Regulations, as they now exist or as they may hereafter be amended. A.8.

During the period in question, 1972-74—the formative years of the Church's existence—Dean Slough, its founder, served as its president, general superintendent, and only minister. He also was its principal donor. During those three years, he made cash contributions to the Church totalling almost $100,000. A. 49-51. (Two other donors contributed $1,000. Tr. 69-70.)

The main focus of this case is the activities of Dean Slough, which represent the activities of the Church. The primary issue is whether those activities were in furtherance of the religious purposes for which the exemption was granted.

There was some activity that was not related to the building fund. As would be expected, it was developmental. It consisted primarily of "one-on-one" proselytizing or "missionary" work by Dean Slough in which he sought new members and counseled them. He

estimated that this took ten to twelve hours per month. These efforts had resulted in obtaining about forty members for the Church. (Slough declined to disclose the names of the members, other than his wife and daughter, for privacy reasons. However, the government has so far never contended that no such members existed.) The Church, through Slough, made minor cash gifts to needy converts or potential converts totalling appriximately $5,000. Slough testified that he considered the practice of his faith to be a twenty-four hour per day project, limited by the time requirements of his businesses.[2]

The principal activity of the Church was the creation of a building fund for the purpose of constructing a church building.

In 1971, an architect designed a building for the Church. See Appendix for a drawing. The projected cost for the entire complex was estimated at four to five million dollars, but it was not contemplated that the entire complex would be constructed at once. Slough believed that the primary function of the Church was to obtain more members, and he felt that the construction of a church building would be important to this end. It was agreed that at least $500,000 should be raised before initiating any construction. At the time of trial, March 14, 1979, the Church had accumulated assets of approximately $190,000 towards this goal. Slough estimated that it would take approximately ten to fifteen years to put the Church into full operation.

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[2] During the years in question Slough owned 100% of the stock and was president of Credit Control Services (a collection service) and Business Management Corporation, which managed real estate.

To accumulate the required capital for the building fund, Slough undertook an investment program, using the contributions to the Church and bank loans obtained by the Church on its own credit. The Church thus acquired certificates of deposit, bought and sold common stocks, and purchased a parcel of real estate. This was a commercial building which the Church leased to Credit Control Services. It was undisputed that this lease was favorable to the Church, was at least at full market value, and provided the Church with a 25% return on its investment. (All maintenance, repair, and other costs and taxes were to be paid by Credit Control Services.)

The Church also purchased two automobiles that were to be used as compensation for two fund raisers who were to be employed by the Church to raise money. When the Church later decided not to employ these individuals, the automobiles were sold to Credit Control Services for an amount in excess of the purchase price, so that the *Church* netted approximately $3,000 on this transaction.

As noted, the Church borrowed money on bank loans to help finance its investments. As the bank had a $75,000-per-borrower loan limit, it was sometimes necessary for Slough or his Business Management Corporation to borrow additional funds which were then in turn loaned to the Church. However, Slough was careful to insure that the terms of these re-loans were such that their benefit inured entirely to the Church, and neither Slough nor his corporation benefited in any way from them.

A question was raised concerning a check from the Church to Deana Hron (Slough's daughter) issued in May, 1974, in the amount of $1,600. However, the evidence demonstrated that this represented funds from

the sale of Mrs. Hron's mobile home which had been used to purchase Colt Industries stock, and that stock had been inadvertently comingled with the Church's stock holdings in the same company. When this error was discovered, upon the sale of such stock, the proceeds attributable to Mrs. Hron's investment were returned to her by that check.

In January, 1975, the Church became a creditor of Slough when it paid his $12,000 bank loan and took his note in that amount at the same rate of interest.

No wages or other compensation were ever received by Slough, his wife or daughter, or any of his businesses from the Church.

REASONS FOR GRANTING THE WRIT

1.

THE DECISION BELOW CONFLICTS WITH THE MAJORITY OF THE COURTS OF APPEALS THAT HAVE CONSIDERED THIS QUESTION, AND ALSO WITH THE DECISIONS OF THIS COURT.

Generally, in order for an organization to be entitled to exemption from federal income taxation under the provisions of I.R.C. § 501(a) and § 501(c)(3), [all references are to the Internal Revenue Code of 1954, unless otherwise indicated], the organization must show "(1) that it was organized exclusively for charitable purposes, (2) that it is operated exclusively for charitable purposes, (3) that no part of its net earnings inured to the benefit of any private shareholder or individual, and (4) that no substantial part of its activities consist of carrying on propaganda or otherwise attempting to influence legislation . . ." *Huron Clinic Foundation v. United States*, 212 F. Supp. 847, 850 (D.S.D. 1962), *remanded by stipulation*, 324 F.2d 43 (8th Cir. 1963).

In the instant case, it is undisputed that the Church was "organized" for religious purposes. The primary issue is whether, during its first three years of operation (1972-74), it was "operated" exclusively for religious purposes.

Treas. Reg. § 1.501(c)(3)-1(a) provides that in order to be exempt as an organization described in § 501(c)(3), an organization must be "operated exclusively for one or more of the purposes specified in such section." Tres. Reg. § 1.501(c)(3)-1(c)(1) elaborates on this by providing "an organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages

primarily in activities which accomplish one or more such exempt purposes specified in § 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." Treas. Reg. § 1.501(c)(3)-1(d)(1)(i) specifies "An organization may be exempt . . . if it is organized and operated exclusively for one or more of the following purposes: (a) Religious, (b) charitable . . ." The definition of "charitable" found in Treas. Reg. § 1.501(c)(3)-1(d)(2) specifically includes "advancement of religion," "erection or maintenance of public buildings" and "relief of the poor and distressed."

The Tax Court and the Court of Appeals concluded that the Church was not operated exclusively for exempt purposes because "No activities were conducted . . . which accomplished the petitioner's stated purpose." This overlooks entirely the fact that the Church engaged in *no* activities *except* activities that were directed toward the primary purposes of *any* new church—the acquisition of members and the creation of a building fund leading to the erection of a church building.

The Tax Court and the Court of Appeals apparently discounted Slough's one-to-one missionary work, despite the fact that it resulted in some forty converts to membership. It is manifest that such activity relates directly to an exempt purpose. *Cf. Travis Smith v. Commissioner*, 60 T.C. 988 (1973). At the very least, it cannot support a finding of operation for *non*-religious purposes, as the statute requires to deny an exemption.

Aside from this, however, it appears that the Tax Court (and therefore the Court of Appeals) based its determination to deny the exemption primarily on its view that the investment activity of the Church was not in furtherance of an exempt purpose. While this might

be true if the investment activity was an end in itself, that is not the case here. It was beyond dispute that the accumulation and investment of funds was for the purpose of a building fund for a church building. Clearly, the erection of a church building is a proper exempt purpose. How, then, can the Church be denied the only means available to it to accomplish that purpose? The holding of the Tax Court takes an impermissibly narrow view of the Church's activity, and if generalized to other exempt organizations, could destroy these organizations before they had a chance to get off the ground.

The Tax Court relied on *Randall Foundation v. Riddell*, 244 F.2d 803 (9th Cir. 1957), as the sole authority for its conclusion. But apart from factual distinctions, the *Randall Foundation* case must be rejected because (1) it does not consider present statutory provisions for dealing with business income of exempt organizations, and (2) it reflects the minority view of the Ninth Circuit Court of Appeals rejecting the "destination of income" test applied in other circuits and derived from the decision of this Court.

A partial review of the history of the tax exempt provisions now embodied in § 501 is useful in understanding the statutory scheme for dealing with the issues raised in this case and why *Randall Foundation* should not be deemed applicable.

The exemption for charitable organizations originated in the Corporate Excise Tax Act of 1909 which exempted ". . . any corporation or association organized and operated exclusively for religious, charitable, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual." § 38, 36 Stat. 112 (1909). This language was carried over as part of the Income Tax Act of October 3,

1913, 38 Stat. 172, 180. This Court considered the effect of business and investment income on an organization's tax exempt status in *Trinidad v. Sagrada Orden*, 263 U.S. 578 (1924). That case involved a religious order that derived approximately 35% of its income from rents and 59% from dividends and interest on investments. The Court rejected the contention that the organization was not operated exclusively for exempt purposes because of its investment and business activities observing:

> "Whether the contention is well taken turns primarily on the meaning of the excepting clause, before quoted from the taxing act. Two matters apparent on the face of the clause go far towards settling its meaning. First, it recognizes that a corporation may be organized and operated exclusively for religious, charitable, scientific or educational purposes, and yet have a net income. Next, it says nothing about the source of the income, but makes the destination the ultimate test of exception.
>
> "Evidently the exception is made in recognition of the benefit which the public derives from corporate activities of the class named, and it intended to aid them when not conducted for private gain. Such activities cannot be carried on without money; and it is common knowledge that they are largely carried on with income received from properties dedicated to their pursuit. This is particularly true of many charitable, scientific and educational corporations and is measurably true of some religious corporations. Making such properties productive to the end that the income may be thus used does not alter or enlarge the purpose for which the corporation is created and conducted." 263 U.S. at 581.

This Court again applied the destination of income test in *Better Business Bureau v. United States*, 326 U.S. 279 (1945), where, in considering the exemption of the BBB from social security taxes under an identical

statutory provision, the Court focused not on the nature of the organization's income but upon the ultimate non-exempt purpose of promoting private business interests.

Following the Supreme Court's decision in *Trinidad*, a split developed among the Circuit Courts of Appeals concerning the proper meaning of the language quoted above. The majority of the courts adopted what is referred to as the "destination of income" test and held that there was virtually no limit on the permissible income producing activities of tax exempt organizations so long as the income would ultimately be used for a tax exempt purpose. *See, e.g., Roche's Beach, Inc. v. Commissioner*, 96 F.2d 776 (2d Cir. 1938); *C. F. Mueller Co. v. Commissioner*, 190 F.2d 120 (3d Cir. 1951); *Willingham v. Home Oil Mill*, 181 F.2d 9 (5th Cir. 1950); *Lichter Foundation v. Welch*, 247 F.2d 431 (6th Cir. 1957); *Bomen v. Commissioner*, 240 F.2d 767 (8th Cir. 1957).

On the other hand, the Ninth and Fourth Circuits adopted a much more restrictive view of the effect of business income upon the ability of an organization to meet the requirement that it be operated exclusively for exempt purposes. Those courts indicated that tax exemption should not be allowed for an organization all of whose income arose from conduct of a trade or business and which arrried on no active charitable activities. *See, e.g., United States v. Community Services, Inc.*, 189 F.2d 421 (4th Cir. 1951); *Ralph H. Eaton Foundation v. Commissioner*, 219 F.2d 527 (9th Cir. 1955).

Commentators who have considered the issue have almost universally reached the conclusion that the majority destination of income test is the correct view because it correctly interprets the opinion of the Supreme Court in *Trinidad* and *Better Business Bureau*,

it is consistent with the wording of § 501, and it is more realistic. *See, e.g.*, Eliasberg, *Charity and Commerce: I.R.C. § 501(c)(3)-. How Much Unrelated Business Activity?*, 21 Tax L. Rev. 53, 73-4 (1965); Strong and Fields, *Profitable Related Business Activities and Charitable Exemption Under I.R.C. § 501(c)(3)*, 44 Geo. Wash. L. Rev. 270, 275-76 (1976).

In the wake of this Court's decision in *Trinidad* and adoption of the "destination of income" test by a majority of the Circuit Court of Appeals, numerous exempt organizations began operating trades and businesses in direct competition with private enterprise. See e.g. *Roche's Beach, Inc. v. Commissioner, supra* (operation of public bathing beach and related concessions); *C. F. Mueller Co. v. Commissioner, supra*, (operation of food manufacturer). By 1950, the business activities of charitable organizations had reached such proportions that Congress felt it was necessary to amend the Internal Revenue Code to "eliminate the unfair competition which exists when a tax-exempt organization engages in competition with taxpaying business." Remarks of Senator George at 96 Cong. Rec. 13273 (1950), S. Rep. No. 2375, 81st Cong. 2d Sess. 28-9 (1950).

The Revenue Act of 1950 included two changes that are relevant to the present case. First, the predecessors of §§ 511-513 were added to the Code to provide for a tax on "unrelated business income" of exempt organizations. Second, a provision was added denying tax exempt status to § 502(c)(3) organizations for, among other things, unreasonably accumulating income. These changes provided a statutory system to deal with business activities of exempt organizations.

The primary means by which Congress chose to eliminate the unfair advantage enjoyed by tax exempt

organizations in competition with private business is by taxing income resulting from an exempt organization's conduct of a trade or business unless such business activity directly accomplishes an exempt purpose. I.R.C. §§ 511-513 provide a detailed explanation of when an exempt organization's income producing activities will be subject to the tax. There has been no allegation that the Church's income from investments in securities falls within the statutory definition of unrelated business income. Also, it is extremely important to note that when Congress considered the problems arising from the destination of income test which allowed tax exempt organizations to engage in trades and businesses unrelated to their charitable goals, the solution it provided was not the denial of an organization's status as a tax exempt organization but merely to impose a tax upon income from the conduct of an unrelated business. As noted in the Senate Report on §§ 511-513:

> "In neither the House bill nor your committee's bill does the provision deny the exemption where the organizations are carrying on related active business enterprises, nor require that they dispose of such business. Both provisions merely impose the same tax on income derived from an unrelated trade or business as is borne by their competitors. In fact it is not intended that the tax imposed on unrelated business income will have any effect on the tax-exempt status of any organization. An organization which is exempt prior to the enactment of this bill, if continuing the same activities, would still be exempt after this bill becomes law." S. Rep. No. 2375, 81st Cong., 2d Sess. 28-29 (1950).

In spite of lengthy Code sections dealing with the tax on unrelated business income, no provision was included that prohibits an exempt organization from engaging in business activities or that attempts to limit the scope of

those activities. Taxation, not prohibition of business activities, was the remedy provided by Congress.

In the Revenue Act of 1950, Congress also provided a means for dealing with unreasonable accumulations of income by organizations exempt from tax under the predecessor of § 501(c)(3). Here, however, Congress chose the harsher remedy of denial of exemption rather than merely providing for a tax on the prohibited accumulations. Section 3814 was added to the Internal Revenue Code of 1939. That section provided that an exempt organization would be denied exempt status for any taxable year in which it had accumulated income that 1) was unreasonable in amount or duration in order to carry out the organization's exempt purpose, 2) was used to substantial degree to carry out a nonexempt purpose or 3) was invested in a manner that jeopardized the carrying out of the organization's exempt purposes. Section 3814 was carried over in the Internal Revenue Code of 1954 as § 504. However, the section was repealed by the Tax Reform Act of 1969.

Against this background it can be seen that the holding of *Randall Foundation v. Ridell, supra,* is inapplicable to this case. In the *Randall Foundation* case, Paul Randall formed the Foundation in 1950 as a California non-profit corporation. The corporate articles provided its purpose was "the promotion and advancement of charitable, religious and educational projects on a non-profit basis." 244 F.2d at 805. Randall donated approximately $20,000 worth of stock to the Foundation and loaned it an additional $155,200 at 2½ per cent interest. During 1950 and 1951, the Foundation used these funds to engage in short term trading of highly speculative oil stocks. On September 12, 1951, the Foundation was notified that its application for tax exempt

status had been denied. Over one year later, the Foundation amended its articles to provide a specific charitable purpose of establishing a home for underprivileged boys. Income taxes were collected from the Foundation for its 1951 and 1952 tax years and the Foundation sued for a refund. The *Randall Foundation* opinion affirms the District Court's judgment in favor of the District Director of Revenue.

The Ninth Circuit Court of Appeals in *Randall Foundation* chose to adhere to its minority view and expressly rejected the "destination of income" test favored by the majority of the Circuit Courts of Appeals. 244 F.2d at 807. As discussed *supra*, the minority view fails to reflect the decisions of this Court in the *Trinidad* and *Better Business Bureau* cases and is not supported by any statutory language. In addition, language used by the Court points up the unrealistic nature of the minority test. The Court observes:

> "An individual who engages in business and intends to give all his gains to charity receives exemption only upon certain gifts in a taxable year. If he continues in the same business but incorporates as Paul Randall did here, he should have not better standing . . ." 244 F.2d at 808.

However, as one commentator has noted regarding this aspect of the minority test:

> "On reflection, the majority approach to this problem appears more realistic. In a situation where X voluntarily obligated himself to pay his entire salary to Y, the minority would say that X has two purposes—to earn his salary, and to turn it over to Y. The majority would say that X's purpose is to confer a benefit upon Y, and his labors are the vehicle through which he accomplished his purpose. The minority would break the thought off too abruptly. It is not a realistic view of human nature

> to say that a man works to work and then pursuant to a completely separate intellectual mandate, turns over his work product to someone else. The two actions are part and parcel of the continuous purpose." Eliasberg, *supra* at 74.

Perhaps more importantly, when Congress considered the problems caused by the business activities of exempt organizations its solution was not a limitation or prohibition on the activities but was only to tax unrelated business income while allowing the organization to retain its exempt status.

Thus, the view of the Ninth Circuit expressed in *Randall Foundation* should not be applied to deny exempt status to the Church because it engaged in investment activities to raise money to build a church building. The correct view is the majority's "destination of income" test which would allow income producing activities so long as the ultimate destination of the income was an exempt purpose. The Church's members had clearly indicated their intent to use the funds for a church, and the Church's corporate articles and by-laws unequivocally commit all funds to charitable purposes. Even if the Church should prove unsuccessful and be forced to liquidate, the articles require all assets to be distributed to another § 501(c)(3) organization where they will be used for an exempt purpose.

Although it seems the reasonableness of accumulations should not be a factor in determining an organization's exempt status subsequent to repeal of § 504, the Tax Court seemed concerned with what it viewed as the remote prospect of the Church accumulating the funds it needs to construct a church in the foreseeable future. Preliminarily it must be noted that the Tax Court based its evaluation of the Church's prospects on faulty assumptions. It apparently considered the entire four to

five million dollars as the goal of the accumulations. However, the Church's voting members on two occasions indicated their intent to start construction as soon as at least $500,000 was accumulated. A glance at the architect's drawing reveals that the $4-5 million dollar estimate covered the eventual cost of a multibuilding complex. Secondly, the Tax Court refers to the fact that the Church raised only about $190,000 after seven years of existence. However, it must be remembered that the great bulk of this sum was accumulated in 1973 and 1974. The uncertainty surrounding the Church's tax exempt status made fundraising impractical in subsequent years.

Randall Foundation also involved the accumulation issue. The Revenue Act of 1950 was effective for only the second of the two years involved in that case and the court did not refer to § 3814 of the Internal Revenue Code of 1939 in its opinion. However, the tests applied closely parallel those found in the statute. Thus, the court stressed the highly speculative nature of the Foundation's investments which endangered the charitable purpose. *Compare* § 3814(3), Internal Revenue Code of 1939. More in point, the court held that:

> "It is not our intention to say that a case can never be made out on the facts of a particular situation for aggregation of funds by a corporation for ultimate disposition to a charitable purpose. But a corporation which in its inception engages in trade, business or speculation, and only has a vague charitable design, does not in our opinion come within the terms of the statute." 244 F.2d 808.

The Church does not contend that the decision of the *Randall Foundation* case on this issue was based on an erroneous view of the law as it existed between the Revenue Act of 1950 and the Tax Reform Act of 1969.

The Foundation in that case had no specific use for its funds at the time they were accumulated. Its charter stated its exempt purposes only in broad, vague terms. It was not until a subsequent year, after denial of exempt status that the Foundation's articles were amended to provide a specific charitable purpose. A number of other cases also concluded that accumulation of funds without some program for their use was an unreasonable accumulation within the meaning of § 504 and thus fatal to the organization's exempt status for taxable years in which it held such accumulations. *E.g.*, *Curt Teich Foundation v. Commissioner*, 48 T.C. 963 (1967), *aff'd per curiam*, 407 F.2d 815 (7th Cir. 1969); *Stevens Bros. Foundation, Inc. v. Commissioner*, 324 F.2d 633 (8th Cir. 1963); *Danforth Foundation v. United States*, 222 F. Supp. 761 (E.D. Mo. 1963). It was also held that "the program must be prospective and not occur to the organization only after the Commissioner's shadow becomes visible. 'After-thoughts will not suffice.'" *Erie Endowment v. United States*, 316 F.2d 151 (3d Cir. 1963).

On the other hand, it seems equally clear that even before repeal of § 504, an organization was allowed to accumulate income for a specific project without losing its exempt status. *E.g.*, *Huron Clinic Foundation v. United States*, 212 F. Supp. 847 (D.J.D. 1962), *remanded by stipulation*, 324 F.2d 43 (8th Cir. 1963) (income accumulated to construct medical clinic building); *Hulman Foundation, Inc. v. United States*, 217 F. Supp. 423 (S.D. Ind. 1962) (accumulation of over $1-1½ million over 14 year period to finance construction of civic center); *Samuel Friedland Foundation v. United States*, 144 F. Supp. 74 (D.N.J. 1954) (accumulation of income to construct medical research facility). In this case, the Church accumulated income to accomplish a specific ex-

empt purpose, construction of a church building. The evidence clearly indicates this plan was adopted well before the Commissioner's shadow became visible. Thus, even under the pre-1969 Tax Reform Act Standards, the Church's accumulation of funds to construct a church building would not have affected its tax exempt status.

More importantly, repeal of § 504 by the Tax Reform Act of 1969 indicates a decision by Congress that accumulation of income should no longer cause the loss of an organization's tax exempt status.

The position urged by the government and adopted by the Tax Court takes far too narrow of view of the activities in question, and arbitrarily and unreasonably ignores the ultimate purpose of those activities. It also overlooks the fact that there was no activity that was shown *not* to be for a proper tax exempt purpose. Could the Tax Court's conclusion be justified if the Church's charter had stated as one of its purposes, "the accumulation of funds for the purpose of constructing a church building"? Yet is not that implicit in the stated purpose to construct such a building?

The decision below, in effect, prevents the vital acquisition of funds for the stated purpose, since without a tax exemption contributions will be impossible to obtain and accumulations, burdened by income taxes, will be slowed to a pace which cannot even hope to match the inflationary spiral.

In short, the decision below cannot be justified under the existing tax laws, the decisions of this Court and the better-reasoned decisions of the Courts of Appeals, or the policies underlying the tax exemption. While the exemption may be a matter of legislative grace, it cannot be arbitrarily and discriminatorily applied by the courts.

It will be time enough to revoke, retroactively, the Church's tax exemption if it ever happens that the funds in question are improperly used, or are used for a non-exempt purpose. Until that time, the Church ought to be entitled to pursue its purposes in the manner dictated by the good faith exercise of its own judgment.

2.

THE DECISION BELOW IMPERMISSIBLY BURDENS NEW CHARITIES AND DISCRIMINATES IN FAVOR OF THOSE WHICH HAVE ALREADY SUCCEEDED IN ESTABLISHING THEIR PROGRAMS.

The decision below amounts to a determination that a new charity must proceed with its activities in accordance with the preconceived ideas of the particular courts that review those activities, and must have succeeded according to the standards of those courts, upon penalty of losing its tax exemption—which amounts to capital punishment. Apart from the manifest injustice of this approach, it raises serious issues concerning, and impinges upon, the rights guaranteed to its members by the First Amendment to the United States Constitution.

There seems to be no doubt that an established religious organization could have engaged in exactly the same activities as the Church without endangering its tax exempt status. See Rev. Rul. 75-282 and discussion *supra*. However, here the Tax Court looked to the number of members and the absence of regular religious services as "relevant factors" in deciding whether the Church would be afforded tax exempt status. This approach focuses not upon the fact of whether the Church is organized and operated to accomplish genuine religious purposes but upon the methods by which the Church seeks to accomplish its purposes and by the ease

with which others can be persuaded to accept its tenets. If the Church was under the control of an established church, if it had adopted tenets that would rapidly attract large numbers of followers or if it had chosen to conduct services prior to construction of a church building, the Tax Court's opinion and Rev. Rul. 75-282 indicate the Church would more likely have been allowed to retain its tax exempt status.

Here, the Tax Court did not base its opinion on the use planned for the Church's funds or the exclusive purposes of the Church's existence, but instead relied on its subjective appraisal of the methods by which the Church undertook accomplishment of its admittedly exempt goals and the court's subjective appraisal of whether its stated goals were realistic. Such insistence upon conforming to its views of the proper mode of operating a religious organization effectively discriminates against new organizations and favors established religious organizations. The Tax Court's approach would force the Church to prematurely undertake activities which would dissipate the funds necessary to construct the church building, which the Church believes is essential to its ability to compete with established religious sects for members, while allowing those associated with an established sect free rein in accumulating funds with which to expand and build new churches.

In *Golden Rule Church Association v. Commissioner*, 41 T.C. 719 (1964) the Tax Court considered the problems inherent in denying tax exempt status to religious organizations that engaged extensively in business activities. The Tax Court observed:

> "As we stated in United School of Christianity, [4 B.T.A. 61 (1926)] at 70:

> In considering whether a corporation is religious, charitable or educational we must always be guided by the character of the organization and its activities. Religion is not confined to a sect or a ritual. The symbols of religion to one are anathema to another. What one may regard as charity another may scorn as foolish waste, and even education today is not free from divergence of view as to its validity. Congress left open the door of tax exemption to all corporations meeting the test, the restriction being not as to the species of religion, charity, science or education under which they may operate, but as to the use of its profits and the exclusive purpose of its exemption.
>
> We have grave doubts that a contrary decision would be permissible under the Constitution of the United States. It is a violation of the first amendment to discrimate between religious organizations. Although tax benefits such as exemptions may be matters of legislative grace, nevertheless, a denial of such benefits granted to others of essentially the same class may well rise to the level of an unconstitutional discrimination." [Citations omitted] 41 T.C. at 729.

3.

THE DECISION BELOW ERRONEOUSLY CONCLUDED THAT SOME PART OF THE NET EARNINGS OF THE CHURCH INURED TO THE BENEFIT OF A PRIVATE INDIVIDUAL.

As an alternative ground for its decision, the Tax Court concluded that the Church had failed to show that it was not operated for the private benefit of Slough and that no net earnings had inured to private individuals. The court expressly stated: "No single factor or combination thereof controls our conclusion. Rather, these

factors, taken in the aggregate, require the conclusion we reach."

We believe that a detailed analysis of these factors is beyond the scope of this petition. However, we submit that this conclusion was essentially makeweight and is manifestly not supported by the record. *All* of the evidence was that in the transactions between Slough and his businesses and the Church, scrupulous care was taken to insure that *no* benefit inured to Slough or his businesses and that the advantage, if any, was the Church's. If this record demonstrates a private benefit, then no charity's tax exemption is safe. Every charity must engage in business transactions with "private individuals," including its own officers and members at times. Presumably, these transactions will usually involve some *mutual* benefit. If that part of the benefit that inures to the private person results in the loss of the charity's tax exemption, how can the charity function and still retain its exemption? Any such rule would be absurd, and yet this very rule is implicit in the decision below. That decision is without precedent. *Huron Clinic Foundation v. United States*, 212 F. Supp. 847 (D.S.D. 1962), *remanded by stipulation*, 324 F.2d 43 (8th Cir. 1963); *Bomen v. Commissioner*, 240 F.2d 767 (8th Cir. 1957).

The government's position is not aided by the fact that the Church is predominately the vehicle of its founder, Dean Slough. The same may be said of the vast majority of churches during their formative years. They have, historically, been the result of the vision and views of some founder. Indeed, even the Internal Revenue Service has indicated that personal control of an organization by its founder will not alone constitute grounds for denial of tax exempt status. Rev. Rul. 66-219, 1966-2

C.B. 208; *see also, Curt Teich Foundation v. Commissioner*, 48 T.C. 963 (1967), *aff'd per curiam*, 407 F.2d 815 (7th Cir. 1969).

The record in the instant case will demonstrate that the benefit that flowed from Slough to the Church far outweighed any incidental benefit to Slough or his businesses, or to any other private individual. It will also demonstrate that that benefit was no different from the benefit that normally accrues to anyone who deals with a charity. The "facts" relied upon by the court will not support any rational analysis based upon the meaning and purpose of this part of the exemption requirements.

CONCLUSION

For these reasons, a writ of certiorari should issue to review the judgment of the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

Argued: September 15, 1980
September 19, 1980

Before

Hon. Harlington Wood, Jr., Circuit Judge
Hon. Richard D. Cudahy, Circuit Judge
Hon. William J. Campbell,* Senior Judge

Western Catholic Church,

Petitioner-Appellant.

No. 80-1083 vs.

Commissioner of Internal Revenue,

Respondent-Appellee.

Appeal from the United States Tax Court
No. 8709-78X—Judge William M. Drennen

ORDER

[Unpublished Order Not To Be Cited Per Circuit Rule 35]

After having reviewed the briefs and heard arguments from the Appellant, the Court is of the opinion that the judgment of the Tax Court should be AFFIRMED. The opinion of the Tax Court is adopted as the opinion of this Court.

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* Honorable William J. Campbell, Senior United States District Judge for the Northern District of Illinois is sitting by designation.

UNITED STATES TAX COURT
Washington

WESTERN CATHOLIC CHURCH,

Petitioner,

No. 8709-78X *v.*

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ORDER AND DECISION

Pursuant to the determination of this Court, as set forth in its Findings of Fact and Opinion filed October 31, 1979, it is

DECLARED, ADJUDGED and DECIDED: That petitioner does not qualify as an organization described in section 501(c)(3), I.R.C. 1954, as amended. Respondent's retroactive revocation of his ruling that petitioner was exempt under section 501(c)(3), I.R.C. 1954, is hereby sustained.

/s/ WILLIAM M. DRENNEN
JUDGE

Entered: October 31, 1979

73 T.C. No. 19

UNITED STATES TAX COURT

WESTERN CATHOLIC CHURCH, Petitioner *v.*
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 8709-78X Filed October 31, 1979

Petitioner was organized in 1971 for religious purposes. However, it had no place of worship and conducted no public religious services during the years 1972-74. Its only activities, aside from investment activities, were some one-to-one ministry conducted by its founder with individuals who had problems, and distribution of a few grants to needy individuals chosen by the founder. Petitioner's capital was derived primarily from contributions by its founder who, with his wife and daughter, constituted the board of directors of petitioner. Petitioner's primary activity during 1972-74 was the passive investment of its funds, which it accumulated to build a church when it had at least $500,000. *Held*: Petitioner was not operated exclusively for an exempt purpose and it has not shown that no part of its net earnings inured to the benefit of private individuals. Respondent's retroactive revocation of his ruling that petitioner was exempt under sec. 501(c)(3) is sustained.

John J. Vassen and *James R. Kalish*, for the petitioner.
Judith M. Picken, for respondent.

DENNEN, *Judge:* This is an action for declaratory judgment pursuant to section 7428(a), I.R.C. 1954.[1]

Respondent issued a final adverse determination to petitioner on April 25, 1978, in which petitioner's previously granted tax-exempt status under section

[1] All section references are to the Internal Revenue Code of 1954, as amended and in effect in the years in issue, unless otherwise specified.

501(c)(3) was retroactively revoked. The revocation was effective as of April 23, 1971, the date petitioner was organized. Based upon an examination of petitioner's activities during the 1972, 1973, and 1974 calendar years, respondent determined that (1) petitioner was not, nor had it ever been, operated exclusively for any of the purposes enumerated in section 501(c)(3); and (2) a portion of petitioner's net earnings had inured to the benefit of private individuals. Petitioner challenges respondent's determination and it has properly invoked the jurisdiction of this Court for a declaratory judgment relating to its qualification as an organization described in section 501(c)(3).[2]

The issues presented are whether petitioner was operated exclusively for a religious purpose[3] and whether a portion of petitioner's net earnings inured to the benefit of private individuals.

FINDINGS OF FACT

Some of the facts were stipulated and are so found. The stipulation of facts and the exhibits attached thereto are incorporated herein by this reference.[4]

Western Catholic Church[5] (hereinafter referred to as petitioner), was incorporated on April 23, 1971, pur-

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[2] Petitioner has satisfied the following prerequisites for a declaratory judgment: It exhausted its administrative remedies, sec. 7428(b)(2); it filed the petition and its qualifications are at issue, sec. 7428(b)(1); and it mailed its petition before the 91st day after respondent mailed his adverse determination in this matter, sec. 7428(b)(3). See also Rule 210(c), Tax Court Rules of Practice and Procedure.

[3] Petitioner does not claim that it was operated for any of the other purposes mentioned in sec. 501(c)(3).

[4] In a declaratory judgment action concerning a revocation of a tax-exempt status, the Court may make findings of fact which differ from the administrative record. Rule 217(b)(1), Tax Court Rules of Practice and Procedure.

[5] The term "Catholic" was used in petitioner's name to mean "universal," rather than any affiliation with the Roman Catholic Church or any other organization which uses the term.

suant to the General Not for Profit Corporation Act of Illinois by S. Dean Slough (hereinafter referred to as Slough), Laura R. Slough, and Deana L. Hron. Laura R. Slough and Deana L. Hron are, respectively, the wife and daughter of Slough. These three individuals also comprised petitioner's board of directors. Petitioner's principal office, at all times relevant herein, was located in Quincy, Ill.

In its articles of incorporation and its by-laws, the following is set forth as the purpose of petitioner:

> To establish a church to embrace persons of all faith[s], color[s], and creed[s], to join for a common cause the betterment of man, by helping God in spreading the Gospel. To recuit [*sic*] evangalists [*sic*], to build, operate and maintain churches, hospitals, nursing homes, schools and to establish missionarys [*sic*] and missions whereever [*sic*] they are needed in the World. We believed [*sic*] the Bible to be the verbally inspired Word of God; the only infallible rule of faith and practice. We believe in the eternal Deity of Our Lord Jesus Chirst; in His virgin birth; in His substitutionary death on Calvary for our sins; in His bearing of our afflictions and in His bodily reserrection [*sic*] from the grave. We believed in salvation by faith through the shed blood of Jesus Christ. We believe that the true church is composed of all those who have been born again. We believe in the present working and moving of the Holy Spirit in the lives of men, women, children; we believe in carry[ing] out the Great Commission. To evangelize is a vital part of our Christian responsibility. We believe all men are lost apart from the saving grace of Jesus Christ. We believe in the return of Jesus Christ, God's only begotten, Son, to this earth.

It was also provided that upon petitioner's dissolution, all assets would be paid to an organization exempt under section 501(c)(3). To accomplish its stated purposes, the articles of incorporation provided that petitioner had the power, *inter alia*, to buy, sell, mortgage, and lease

real and personal property, to borrow money, and to invest in stocks and bonds.

On or about May 18, 1971, petitioner filed an application for recognition as a religious organization described in section 501(c)(3) and as exempt from taxation under section 501(a). Petitioner's stated purpose was "to further religion and benefit mankind." In the application petitioner described its proposed activities as including the building of churches, colleges, nursing homes, and a hospital. Petitioner noted that it had not engaged in any of these activities as of the time it filed its application. Funds were to be raised by donations.

Following an interchange of letters between petitioner and the District Director, St. Louis, Mo., in which it was suggested to petitioner that it amend its articles of incorporation and its by-laws in certain respects,[6] which suggestions petitioner adopted, the District Director determined by letter dated October 31, 1971, that petitioner was exempt from Federal income tax under section 501(c)(3). The exemption was based on information supplied by petitioner and it was conditioned on the assumption that petitioner's operations would be as stated in the application for exemption. Petitioner was also informed that it had to report any change in its purposes, character, or method of operation. The letter also specifically stated that no determination was made as to whether any of petitioner's proposed activities would give rise to unrelated business income subject to tax under section 511.

By letter dated July 10, 1974, the Regional Commissioner notified petitioner that an examination would be conducted in order to establish petitioner's continuing qualification as an exempt organization. The examination was commenced on August 20, 1974, and it covered the calendar years 1972, 1973, and 1974. As a result of

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[6] One letter advised petitioner that its proposed activities of "building additional churches, a college, a hospital and nursing homes" would require separate exemption applications inasmuch as each would be considered separate entities.

this examination respondent revoked petitioner's tax-exempt status.

Prior to petitioner's incorporation and during the years in question, Slough was president and owned 100 percent of the stock of both Credit Control Services, Inc., and Business Management Corp. Credit Control Services was in the business of collecting bad accounts. Business Management Corp. had some real estate holdings. Slough was also involved in a number of other business enterprises. Slough devoted full time to his business enterprises.

Slough decided to organize petitioner for two reasons: (1) In order to help other people; and (2) to have an organization in which Slough could be active and dictate some of the policies. Slough estimated it would take 10 to 15 years to get the program into operation.

During the years under examination, petitioner neither conducted religious services nor performed religious functions on a group basis.[7] Slough was petitioner's only minister, having been ordained by action of the voting members at the annual meeting held on May 15, 1972.[8] He had no theological training prior to that time or between then and the time of trial. No other minister was hired by petitioner, Slough preferring to retain petitioner's money in its building fund.

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[7] In 1975 Slough made arrangements with a church in Ohatchee, Ala., to hold group services for petitioner. The pastor of this church was a former business partner of Slough.

[8] At the same meeting the members of the board of directors present were Slough, his wife, and his daughter. These individuals voted themselves into the following offices:

Slough	—	president
Diana Hron	—	vice-president
Laura Slough	—	secretary
Slough	—	treasurer

In its application for recognition as a tax-exempt organization, petitioner stated that no proposed member of the board or officers would be related, *inter alia*, by blood or marriage.

Although petitioner did not conduct services, Slough claimed he met on a one-to-one basis with individuals he knew in Quincy, Ill., and he attempted to get these individuals to commit themselves to become members of petitioner. He also counselled individuals with personal problems.[9] Slough believed that the growth of petitioner could be better accomplished by talking to people on a one-to-one basis than by holding religious services which were not well attended. Only Slough engaged in this one-to-one activity. He spent approximately 10-12 hours per month engaged in petitioner's activities. Although Slough claimed that there were 40 members of petitioner, only Slough, his wife and daughter, and two other individuals, one of whom was a former employee of Slough and the other of whom knew Slough prior to the incorporation of petitioner, have been identified as members. All it took to become a member was to accept the principles of petitioner and to agree to attend services when held in the future. Slough refused to divulge any list of petitioner's members, claiming such a divulsion would be an invasion of privacy. With the exception of Slough's wife's and daughter's participation in petitioner's annual meetings, evidence was not introduced to indicate that any individual other than Slough performed any activity for petitioner.

Slough has never received any salary or other form of compensation from petitioner and neither has Slough's wife, daughter, or businesses.

During 1972 Slough wrote checks to cash totaling $5,200 on petitioner's checking account. The principal evidence of the disposition of this money was Slough's testimony that the money was donated to individuals known to Slough and whom Slough personally determined to be in need of money. The individuals to whom the payments were made did not apply to petitioner for

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[9] Slough also testified that he performed wedding ceremonies. Although it is not clear when these ceremonies were conducted, it has not been established that they were conducted during 1972-1974.

money. Slough considered these payments as a function of petitioner. The revenue agent who conducted the examination of petitioner was able to contact only one of the identified recipients. This individual verified that he received money from petitioner.

Petitioner stopped donating money following the advice of a certified public accountant to the effect that petitioner's inability to document what happened to the money would be troublesome if petitioner was audited. Slough chose to discontinue making payments rather than set up a bookkeeping procedure which he considered unnecessary for an organization that was not required to file tax returns.

For the taxable year ending December 31, 1972, Slough filed a joint return with his wife on which adjusted gross income of $61,258 was reported. From this amount itemized deductions of $34,536 were subtracted, of which amount $29,975 represented contributions to petitioner. For the taxable year ending December 31, 1973, a joint return was filed on which was reported adjusted gross income of $126,990.17. From this amount itemized deductions of $73,064.37 were subtracted, of which amount $63,495 represented contributions to petitioner.[10] For the taxable year ending December 31, 1974, a joint return was filed on which was reported adjusted gross income of $64,945. From this amount itemized deductions of $18,006 were subtracted, of which amount $6,370 represented charitable contributions.[11]

The parties stipulated that during 1972, 1973, and 1974, petitioner received the following amounts from Slough in the form of cash or checks deposited to petitioner's checking account:

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[10] Although contributions totaled $69,705, the sec. 170(b)(1) percentage limitation reduced the allowable charitable contribution deduction to $63,495.

[11] Of the charitable contribution deduction, $6,210 is the carryover of excess contributions from the preceding taxable year.

Year	Amount
1972	$7,000
1973	78,830
1974	12,150
Total for 3 years	$97,980

No explanation was provided concerning the difference between the amounts deducted on the joint returns as charitable contributions to petitioner and the amounts which the parties stipulated were given by Slough to petitioner. Only two other individuals were identified as having contributed to petitioner, each having contributed $500. One of these individuals was a previous recipient of funds from petitioner.

It was represented in petitioner's application for exemption that petitioner would not receive 10 percent or more of its assets from any single organization or group of affiliated organizations or from any individual or members of a family group. Of petitioner's accumulated assets, estimated at approximately $190,000 as of the time of trial, Slough's contributions for the years under examination totaled $97,980.[12]

In 1971 petitioner requested John A Benya, an architect, to design a church building. Mr. Benya worked without charge in his spare time and he completed a preliminary drawing of an elaborate church. The cost of the building, as conceptualized by Mr. Benya, was estimated to be $4-$5 million. As of the time of trial,[13] this estimate was considered low due to inflation. Plans to build a church never went beyond this preliminary drawing stage. The minutes of petitioner's annual meeting of voting members on May 15, 1973, reflect that it was agreed that at least $500,000 should be collected before any building project was started. This decision

[12] No evidence was introduced concerning Slough's contributions to petitioner for years subsequent to those under examination. Apparently a part of the accumulated assets represented gain on petitioner's securities transactions and dividends and interest received on its investments.

[13] Trial was held in this case on Mar. 14, 1979.

was reaffirmed at the annual meeting held on May 15, 1974.[14] Slough thought the overall success of the organization would come more quickly if a large church building was constructed.

During the years under examination, petitioner's primary activity has been one of making passive investments in order to accumulate money for the building fund. These investments were principally in certificates of deposit, stocks, and real estate. Petitioner borrowed considerable amounts of money from banks in order to finance its investment activity. At times either Slough individually or one of his businesses would borrow money for petitioner. Slough or one of his businesses also provided the collateral for some of petitioner's bank loans. There was conflicting testimony as to whether petitioner repaid all amounts borrowed on its behalf, and it cannot be determined from the documentary evidence whether all repayments were made. Neither Slough nor his businesses charged petitioner for any amount in excess of what the bank charged them when loans were obtained for petitioner's benefit.

Petitioner had no assets at the time of filing its application for exemption. The only records maintained by petitioner for the period 1972 through 1974 were check stubs and minutes of annual meetings.[15] Initial contributions to petitioner were made by Slough. At the beginning of 1972, petitioner's only assets were the following three certificates of deposit:

Certificate of deposit number	Issuance date	Market value
5330	Oct. 15, 1971	$ 5,000
5348	Nov. 26, 1971	6,000
5354	Dec. 21, 1971	10,000

[14] The minutes do not identify any "voting members" as being present other than the three directors.

[15] As a result, it was often difficult to retrace petitioner's financial dealings. This difficulty was compounded by petitioner's practice of applying checks received from its stock brokerage account directly against outstanding loans without first depositing the checks into petitioner's checking account.

Said certificates had 12-month maturity periods and 5½ percent interest rates.

During the period under examination petitioner acquired four certificates of deposit and a single time-savings certificate with a total market value of $42,500. Two of the certificates of deposit, with a total market value of $15,000, were transferred to petitioner from Credit Control Services.

During 1972, 1973, and 1974, petitioner transacted the following loans at 7½-percent and 8-percent interest rates:

Loan No.[16]	Date	Amount	Type
1	Oct. 12, 1972	$7,000	Commercial
2	Dec. 15, 1972	7,000	Commercial
3	Dec. 15, 1972	7.500	Commercial
4	May 2, 1973	20,000	Business
5	May 3, 1973	62,000	Commercial
6	Aug. 17, 1973	32,500	Commercial
7	Oct. 9, 1973	13,000	Commercial
8	Nov. 16, 1973	32,000	Commercial
9	Dec. 3, 1973	20,500	Commercial
10	Feb. 8, 1974	7,150	Commercial
11	Feb. 26, 1974	28,600	Commercial
12	Mar. 15, 1974	32,500	Real Estate

[16] For purposes of clarity, sequential numbers were substituted for the actual loan numbers.

Loan No.	Actual No.
1	916.23
2	1047.25
3	1048.25
4	11,679
5	1384.21
6	1704.21
7	1911.21
8	2022.21
9	2075.21
10	2305.26
11	2349.26
12	2401.33

With the exception of Loan number 4, petitioner obtained the loans from the South Side Bank of Quincy, Ill. (subsequently the Town & Country Bank). Loan number 4 was obtained from Lewistown State Bank, Lewistown, Mo.

With the exception of the proceeds from loan numbers 1, 2, 7, and 12, the ultimate use of the loan proceeds was not disclosed. Most of these loan proceeds were deposited in petitioner's checking account.[17]

The proceeds of loan number 1 were used by petitioner to purchase a new 1973 Lincoln Continental 2-door coupe for a total sales price of $7,080.49 on October 12, 1972. No sales tax was paid. Two of petitioner's certificates of deposit were assigned as security for the loan. This loan was repaid by petitioner on December 11, 1972.

The proceeds of loan number 2 were used by petitioner to purchase a new 1973 Lincoln Tour Car 4-door sedan for a total sales price of $7,556.92 on December 14, 1972. No sales tax was paid.

The two automobiles were purchased in anticipation of two fund raisers being hired to work for petitioner. The automobiles were to be a part of the fund raisers' compensation. Subsequent to the purchase of the automobiles, however, Slough decided not to hire the two individuals. Both automobiles were then sold to Credit Control Services on January 5, 1973, for a total price of $17,749.66.[18] The terms of the sale required Credit Control Services to assume petitioner's $14,500

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[17] Evidence was also introduced that an employee of Credit Control Services, Ben Fresno, without authorization, secured a loan and opened a stock brokerage account in petitioner's name. Fresno was not connected with petitioner in any way, and he did not have authority to use petitioner's name. Petitioner did not repay the loan nor did it benefit from the loan proceeds or the stock brokerage account.

[18] No evidence was introduced as to petitioner's use of the automobiles between the time of their purchase and their sale.

liability under loan numbers 2 and 3[19] and to execute a demand note at 7½ percent interest for the $3,249.66 balance. Loan numbers 2 and 3 were repaid in 1973 by Credit Control Services. As of December 31, 1974, neither the demand note nor any interest thereon had been paid. Credit Control Service claimed depreciation deductions for the two automobiles as a business expense.

Slough obtained a loan of $55,000 which was applied to petitioner's loan number 5 ($62,000), and Business Management Corp. obtained a loan of $10,000 of which $7,000 was applied to petitioner's loan number 5.

The proceeds from petitioner's loan number 7 were used to repay Slough and Business Management Corp. in part for their payments on petitioner's loan number 5. Of the $13,000 loan proceeds, $10,000 was paid to Business Management Corp., which was $3,000 more than petitioner owed Business Management Corp. The remaining $3,000 was applied against Slough's personal loan of $55,000. Slough thereafter paid off the balance of his personal loan as follows: (1) Petitioner's interest income check of $3,333.60; (2) petitioner's check of $44,154.93 received from its stock brokerage account at Lamson Bros. & Co. on October 2, 1973, *infra*; and (3) a $4,511.47 check written on petitioner's checking account.

Proceeds from loan number 12 were used in March 1974 to purchase an office building for $45,000.[20] The difference between the purchase price and the $32,500 loan was given to petitioner by Credit Control Services and treated as advance rentals by Credit Control Services. The building was purchased because of its invest-

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[19] Evidence was not presented concerning petitioner's use of the proceeds of loan number 3.

[20] The purchase price of the building was stipulated by the parties to be $45,000. Other evidence was introduced which indicates that the purchase price was $45,500. This latter amount was also the sum of the loan and the advanced rentals received by petitioner. The $500 difference is not important to resolution of this case, however.

ment potential and because Credit Control Services needed more office space. Under the terms of the lease, Credit Control Services leased the entire building, except for two rooms, at a monthly rental of $1,000. Credit Control Services was also required to pay all real estate taxes, maintenance, and insurance. The rent paid by Credit Control Services was reasonable. One of the rooms in the building could have been used for religious services.

On or about January 29, 1974, petitioner made a payment of $12,000 to Town & Country Bank (formerly the South Side Bank of Quincy) which was applied to Slough's loan account at the bank. Slough signed a note payable to petitioner evidencing the $10,000 loan.

In May 1973 petitioner opened an account with Lamson Bros. & Co. stock brokerage firm. A second account was opened in October 1974. Slough made the investment decisions for petitioner. Neither Slough, his family, nor any of his businesses had a stock brokerage account with Lamson Bros. & Co. During 1973 petitioner purchased 21,300 shares of stock in 24 separate transactions for a total cost of $379,361.69. In 9 transactions petitioner sold 11,000 shares of stock for a profit of $25,569.59. As of December 31, 1973, petitioner had 10,300 shares in its account at a total cost of $182,812.30. During 1974 petitioner purchased 30,800 shares of stock in 20 separate transactions for a total cost of $239,845. In 20 transactions petitioner sold 14,500 share of stock for a profit of $25,885.18. As of December 31, 1974, petitioner had 27,900[21] shares of its accounts at a total cost of $175,670.01.

In May 1974 a cashier's check in the amount of $1,600 was issued to Deana Hron. The source of the funds for

[21] The parties stipulated to the number of shares bought, sold, and retained by petitioner. No explanation is provided for the difference between the number of shares stipulated as being held by petitioner as of Dec. 31, 1974, and the remainder arrived at by subtracting the total shares sold from the total shares purchased.

this check was a check from Lamson Bros. & Co. payable to petitioner.

By letter dated June 9, 1976, petitioner was informed by the District Director, St. Louis, Mo., that respondent proposed to revoke petitioner's tax-exempt status. A copy of the revenue agent's examination report was attached to the letter and it set forth the reasons for the proposed revocation, including the failure of petitioner to meet the operational test and the inurement of net earnings to the benefit of private individuals. As previously noted, respondent issued a final adverse determination on April 25, 1978.

OPINION

Section 7428(a) permits this Court under certain circumstances to make a declaration with respect to a final determination by respondent that a corporation is not an organization described in section 501(c)(3) and therefore, not exempt from tax under section 501(a).[22] The term "determination" includes a revocation of an organization's tax-exempt status. Sec. 7428(a). The burden of proof is on petitioner to overcome the grounds for revocation of the exemption set forth in respondent's

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[22] Sec. 7428(a) provides in pertinent part:

(a) Creation of Remedy.—In a case of actual controversy involving—

(1) a determination by the Secretary—

(A) with respect to the initial qualification or continuing qualification of an organization as an organization described in section 501(c)(3) which is exempt from tax under section 501(a) * * * .

* * *

upon the filing of an appropriate pleading, the United States Tax Court * * * may make a declaration with respect to such initial qualification or continuing qualification. * * * Any such declaration shall have the force and effect of a decision of the Tax Court * * * and shall be reviewable as such. * * *

determination. Rule 217(c)(2)(i), Tax Court Rules of Practice and Procedure.[23]

Section 501(a) and section 501(c)(3)[24] provide an exemption from Federal income tax for an organization if three conjunctive requirements are met: (1) The organization must be organized and operated exclusively for an exempt purpose; (2) no part of the net earnings of the organization can inure to the benefit of any private shareholder or individual; and (3) no substantial part of the activities of the organization includes carrying on propaganda, otherwise attempting to influence legislation, or participating or intervening in any political campaign. Failure to satisfy any of these requirements results in a denial of tax-exempt status. *Hancock Academy of Savannah, Inc. v. Commissioner*, 69 T.C. 488, 492 (1977); *Harding Hospital, Inc. v. United States*, 505 F. 2d 1068 (6th Cir. 1974). Respondent based his

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[23] *Hancock Academy of Savannah, Inc. v. Commissioner*, 69 T.C. 488, 492 (1977).

[24] Sec. 501. Exemption From Tax on Corporations, Certain Trusts, Etc.

(a) Exemption From Taxation.—An organization described in subsection (c) * * * shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

* * *

(c) List of Exempt Organizations.—The following organizations are referred to in subsection (a):

* * *

(3) Corporations * * * organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, * * * no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

determination on the grounds that petitioner failed to satisfy requirements (1) and (2) above.

Respondent concluded that petitioner failed the "operated exclusively for a religious purpose" test because (1) petitioner did not actively engage in any religious-type functions in furtherance of its stated purpose; (2) petitioner's primary activity was the making of passive investments and accumulating income therefrom, which activity was not in furtherance of an exempt purpose and did not qualify it for tax-exempt status; and (3) some of petitioner's financial activities were for the benefit of private interests. Respondent's conclusion that petitioner had also failed the "inurement of net earnings" test is based on the assertion that petitioner has failed to establish that net earnings did not inure to the benefit of a private shareholder. In support of this assertion respondent principally points to petitioner's inability to definitively document its financial dealings due to petitioner's inadequate records.

Petitioner asserts that its primary activities were the conversion of members through one-to-one missionary work by Slough and the accumulation of a fund for the construction of a church building, both of which were in furtherance of an exempt purpose. Petitioner further argues that the absence of any statutory or regulatory guidelines concerning minimum religious functions precludes the denial of exempt status on those grounds. Petitioner further contends that, in the absence of any statutory guidelines as to minimum activities, the main thrust of section 501(c)(3) is to prohibit organizations whose activities inure to the private benefit of shareholders from attaining tax-exempt status. Petitioner attempts to establish that it has factually satisfied the "inurement of net earnings" test by showing that all the transactions entered into by petitioner were for the financial benefit of petitioner.

Section 1.501(c)(3)-1(c)(1), Income Tax Regs., provides that an organization is not operated exclusively for an exempt purpose if more than an insubstantial part of its

activities is not in furtherance of an exempt purpose.[25] Section 1.501(c)(3)-1(d)(1), Income Tax Regs., further provides that an organization is not operated exclusively for an exempt purpose if it serves a private rather than a public interest.[26] Section 1.501(c)(3)-1(c)(2), Income Tax Regs., provides that an organization is not operated exclusively for an exempt purpose if its net earnings in whole or in part inure to the benefit of a private individual.[27]

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[25] Sec. 1.501(c)(3)-1(c)(1), Income Tax Regs., states:

An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

[26] Sec. 1.501(c)(3)-1(d)(1)(i) and (ii), Income Tax Regs., states:

(i) An organization may be exempt as an organization described in section 501(c)(3) if it is organized and operated exclusively for one or more of the following purposes:

(*a*) Religious,
(*b*) Charitable,
(*c*) Scientific,
(*d*) Testing for public safety,
(*e*) Literary,
(*f*) Educational, or
(*g*) Prevention of cruelty to children or animals.

(ii) An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

[27] Sec. 1.501(c)(3)-1(c)(2) states:

An organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole

(Footnote continued on following page)

The Supreme Court, in interpreting section 811(b)(8) of the Social Security Act, 49 Stat. 620, 639 (1935), which provided an exemption for corporations organized and operated exclusively for educational purposes, said in *Better Business Bureau v. United States*, 326 U.S. 279, 283 (1945):

> [I]n order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truely educational purposes. * * *

The quotation from *Better Business Bureau* relates to "purpose" while section 1.501(c)(3)-1(c)(1), Income Tax Regs., relates more to "activities." In *Christian Manner International, Inc. v. Commissioner*, 71 T.C. 661, 668 (1979), it was stated:

> Under the rationale of *Better Business Bureau* the existence of a substantial nonexempt purpose for a corporation's organization and existence would appear to defeat the exemption. But under the regulation, even if there was no nonexempt purpose for the organization and existence of the entity, it must actually engage primarily in activities which accomplish one of the exempt purposes, and if more than an insubstantial part of its activities do not further such exempt purpose, the entity is not exempt. It has been recognized, however, that an

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[27] *continued*
or in part to the benefit of private shareholders or individuals. For the definition of the words "private shareholder or individual", see paragraph (c) of §1.501(a)-1.

This prohibition against private inurement of net earnings appears redundant, since such a benefit would be inconsistent with operating exclusively for an exempt purpose. See *Lowry Hospital Association v. Commissioner*, 66 T.C. 850, 857, fn. 8 (1976); *B.H.W. Anesthesia Foundation, Inc. v. Commissioner*, 72 T.C. ....., ... (1979).

> organization engaged in a single activity may have more than one purpose in conducting the activity. *B.S.W. Group, Inc. v. Commissioner*, 70 T.C. 352, 357 (1978). So we must be concerned with both the actual as well as the stated purposes for the existence of the organization and the activities it engages in to accomplish those purposes. What those purposes are and what purposes the activity or activities engaged in support are questions of fact. *Pulpit Resource v. Commissioner*, 70 T.C. 594 (1978).

There is no question that, based on its articles of incorporation, petitioner was *organized* for a religious purpose. No activities were conducted, however, which accomplished the stated purpose.

Petitioner argues that it conducted two activities in furtherance of its exempt purpose: (1) One-to-one missionary work by Slough; and (2) accumulation of a building fund. For the reasons set forth below, we conclude that these activities are not in furtherance of petitioner's stated purpose.[28]

During the years under examination, petitioner did not conduct religious services.[29]

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[28] Although Slough testified that he considered the money he allegedly distributed to needy individuals a function of petitioner, it was not cited by petitioner as an activity in support of its stated purpose. Considering that this activity was conducted for only a short time in 1972, it would not aid petitioner's case. Furthermore, it has been held under similar circumstances that grants made on a personal basis rather than in an objective and nondiscriminatory manner do not constitute an activity in furtherance of an exempt purpose. *Church In Boston v. Commissioner*, 71 T.C. 102, 107 (1978).

[29] Respondent cites the absence of any such services as evidence that petitioner was not operated exclusively for tax-exempt purposes. Petitioner argues that the absence of any statutory or regulatory guidelines concerning minimum religious functions precludes the denial of exempt status on those grounds; that to deny petitioner tax-exempt status solely because it failed to conduct religious services would run afoul

(Footnote continued on following page)

In addition to Slough, his wife, and his daughter, positive evidence was introduced to identify only two other individuals as members of petitioner. Slough claimed that petitioner had 40 members, but he refused to reveal their identities claiming it would be an invasion of privacy.

Objective evidence of the number of petitioner's members is certainly relevant to our inquiry concerning the nature of the activities of petitioner and whether it was operated exclusively for religious purposes. *Bronner v. Commissioner*, 72 T.C. 368 (1979). Since petitioner bears the burden of proving that it is entitled to tax-exempt status, and in the absence of objective evidence indicating a greater number, the Court must proceed as if petitioner had only 5 members. This is not to say that an organization of such small dimensions cannot qualify for tax-exempt status.[30] It is certainly relevant, however, in determining the extent of Slough's one-to-one activities, which petitioner claims as one of its religious activities.

The only evidence of Slough's one-to-one activity was the generalized testimony of Slough and the testimony of two other witnesses to whom Slough had talked. Both of the other witnesses were acquaintances of Slough's prior to the formation of petitioner. While they both agreed to become members of petitioner, there is no evidence that they actually did become members or that they par-

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[29] *continued*
of the First Amendment guarantee of freedom of religion; and that any attempt to set forth guidelines concerning the type of religious activity necessary to qualify for tax-exempt status would be constitutionally suspect. Nonetheless, the type of activities engaged in by an organization is central to our inquiry as to whether that organization is operated exclusively for tax-exempt purposes. Had petitioner conducted services, it certainly would have been a factor to consider. Its not doing so, however, while not a negative factor per se, is something which must be considered given the stated purpose of petitioner to build churches in which, presumably, religious services would be held.

[30] See *Blake v. Commissioner*, T.C. Memo 1970-117.

ticipated in any way in religious functions with petitioner. The evidence indicates that all it took to become members of petitioner was to accept petitioner's general tenets and agree to attend future services. One of these witnesses was the recipient of a grant from petitioner, and both apparently had some personal problems that Slough discussed with them. The amount of time spent by Slough on such discussions was minimal, and we believe Slough's efforts were motivated more by personal reasons than in preaching the gospel. At best Slough's ministeries were directed to the problems of private individuals rather than to the public at large. See *Callaway Family Association v. Commissioner*, 71 T.C. 340 (1978). Petitioner has failed to convince us that this one-to-one activity of Slough was a religious activity conducted in behalf of petitioner. And the evidence indicates that no one other than Slough performed any activities in behalf of petitioner.

Illustrative of the fact that Slough's activities were more personal than church oriented is the manner in which Slough selected the individuals who allegedly received the money from the checks Slough wrote on petitioner's bank account to cash. Slough testified that the individuals selected were people whom Slough personally knew to be in need of funds. These individuals neither applied to Slough nor to petitioner. Rather, Slough unilaterally selected them. The grants were not made in an objective and nondiscriminatory manner based on established criteria. It has been held that grants made on a personal basis do not constitute exempt activity. *Church In Boston v. Commissioner*, 71 T.C. 102 (1978). This type of personal activity by Slough, while commendable, cannot be said to be the activity of petitioner.

Petitioner's primary, if not sole, activity was the making of passive investments. This included investments in certificates of deposit, stocks, and real estate. It borrowed considerable amounts of money in order to finance its investment activities. During both 1973 and 1974 it made a profit in excess of $25,000 from its buying and selling of stocks.

Petitioner's involvement in a moneymaking activity is not a per se bar to qualification as a tax-exempt organization. *Aid to Artisans, Inc. v. Commissioner*, 71 T.C. 202, 211 (1978); *Pulpit Resource v. Commissioner, supra; Orton v. Commissioner*, 56 T.C. 147 (1971). The question is what purpose is accomplished by this activity. The avowed purpose was to make a profit in order to accumulate money with which to build a church. Thus the Court is not presented with a case where the moneymaking activity, in and of itself, accomplished an exempt purpose. Compare *Pulpit Resource v. Commissioner, supra; Orton v. Commissioner, supra; Saint Germane Foundation v. Commissioner*, 26 T.C. 648 (1956).

However, the prospects of accomplishing the avowed purpose at any time in the foreseeable future appears remote. While an architect friend of Slough's had made preliminary sketches of an elaborate church building during his spare time, nothing had been done to follow through on the design. Slough testified that it would have cost $4-5 million to build such an edifice at the time it was sketched and that due to inflation the cost would be considerably more today. Slough testified that petitioner had about $190,000 in assets at the time of trial, 7 years after petitioner was formed. About $50,000 of this amount was produced by petitioner's investment activities, and most of the balance came from contributions by Slough who had contributed almost $100,000 to petitioner by the end of 1974. There is no evidence that petitioner solicited either the public or its members for contributions.[31]

The facts present in the instant case are similar to those in *Randall Foundation v. Riddell*, 244 F. 2d 803 (9th Cir. 1957). In *Randall Foundation* the principal activity of the organization was securities trading. Most of

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[31] Apparently the only other contributions received by petitioner were two contributions of $500 each, but we cannot be certain that these were not repayments of cash given the contributors by Slough.

the profit earned from such activity was accumulated, although small charitable contributions were made. Testimony was introduced in that case to the effect that the accumulated funds were to be used for a boys' home but that more funds were needed before that objective could be pursued. In holding that the organization's principal activity was the trading of stocks and that it was not tax exempt, the Court stated:

> It is not our intention to say that a case can never be made out on the facts of a particular situation for aggregation of funds by a corporation for ultimate disposition to a charitable purpose. But a corporation which in its inception engages in trade, business or speculation, and only has a vague charitable design, does not in our opinion come within the terms of the statute. * * * [Fn. omitted; 244 F. 2d at 804-805.]

As in *Randall Foundation* petitioner had no obligation to use the accumulated funds for the avowed purpose. The similarities between the two cases as to the nature of the profit-making activities, the accumulation of those profits, and the vague, ultimate, albeit potentially exempt, disposition of those profits makes *Randall Foundation* difficult to distinguish. We therefore find that petitioner was not primarily engaged in activities which accomplished a tax-exempt purpose.

In addition, petitioner has failed to convince us that petitioner was no more than insubstantially operated for the private benefit of Slough or that no net earnings inured to the benefit of private individuals. The prohibition against operation of an organization for a private benefit is but another way of requiring that an organization be operated exclusively for tax-exempt purposes, i.e., for public benefit. Sec. 1.501(c)(3)-1(d)(1)(i) and (ii), Income Tax Regs. Although the requirement that an organization be operated exclusively for tax-exempt purposes (and not for a private benefit) is statutorily distinct from the prohibition against the inurement of net earnings to the benefit of private individuals, for convenience both requirements will be discussed together

because much of the evidence is applicable to both.[32] No single factor or combination thereof controls our conclusion. Rather, these factors, taken in the aggregate, require the conclusion we reach.

Slough testified that one of his reasons for organizing petitioner was to have an organization in which he would participate and dictate some of the policies. The amount of control Slough exercised over petitioner's operations and the blurring of the lines of demarcation between the activities and interests of petitioner, Slough, and Slough's wholly owned corporations makes it impossible to conclude that petitioner was operated for a public benefit rather than a private interest.

Slough made large contributions to petitioner for which he took charitable contribution deductions. This money, however, never passed out of Slough's control since he dominated petitioner. Nor was any substantial portion of this money ever expended other than for investment purposes. Thus, in effect, Slough was able to reduce his current taxable income for donations which never left his control. In addition, one of the reasons for petitioner's purchase of an office building, its only investment in real estate, was Credit Control Services' need for more office space. Petitioner's downpayment for the building was provided by Credit Control Services as advance rental and the building was leased under a net lease. Thus, Credit Control Services was able to currently deduct the "cost" of the building. It was also able to use petitioner's credit. It is recognized that the office building may have been a good investment for petitioner and that Credit Control Services paid a reasonable rent. Nevertheless, when petitioner's investments are dictated in part by the needs of private interests, it cannot be said that petitioner was operated exclusively for the public benefit.

Considerable evidence was introduced concerning petitioner's financial transactions. There is a dispute between the parties about whether, as a result of several

[32] See fn. 27.

transactions, Business Management owed petitioner $3,000 or petitioner owed Business Management $10,000. Petitioner's failure to keep adequate records and the manner in which money was handled and loans were paid makes it impossible to trace completely petitioner's financial transactions. In any event, it is clear that money passed back and forth between petitioner and Slough and his businesses whenever one or the other needed the cash. Petitioner was utilized by Slough as an "incorporated pocketbook" into which he could transfer excess personal funds, claiming tax deductions, while he still retained complete control of the funds and used them for purposes unrelated to religious activities. Meanwhile, the income and gain from petitioner's investment activities was intended to be tax free. And based on past history, this situation will continue to exist for a long time. And even if petitioner should eventually build a church and conduct public services, Slough would, presumably, continue to control the use of its funds. As he testified, one of the reasons Slough organized petitioner was to have an organization in which he could participate and dictate policies.

In addition, petitioner failed to introduce adequate evidence to prove that Slough's writing of $5,200 in checks to cash and the payment of $1,600 to Slough's daughter did not inure to the benefit of private individuals. Slough's testimony alone is not sufficient. It was not only uncorroborated by records or the testimony of other witnesses but his explanation of why the $1,600 was given to his daughter was inconsistent with the explanation he had given the revenue agent.

Based on the evidence produced, we cannot conclude that as a result of its financial transactions, no part of petitioner's net earnings inured to the benefit of Slough or members of his family or one of his wholly owned corporations. In view of petitioner's burden of proof, this question must be resolved in favor of respondent.

In summary, we conclude that petitioner was not operated exclusively for a purpose exempt under section 501(c)(3), that petitioner has failed to establish that no

part of its net earnings inured to the benefit of a private individual, and that respondent properly revoked petitioner's previously granted exemption.[33]

An appropriate order will be entered.

[33] Petitioner does not make the alternative argument that regardless of whether it is entitled to tax-exempt status, the respondent's determination should not be retroactively applied. In view of respondent's authority to retroactively revoke the tax-exempt status of an organization, sec. 7805(b), sec. 1.501(a)-1(a)(2), Income Tax Regs., this issue need not be addressed.

INTERNAL REVENUE CODE OF 1954

§ 501. Exemption from tax on corporations, certain trusts, etc.

(a) *Exemption from taxation.*—An organization described in subsection (c) or (d) or section 401(a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502 or 503.

(b) *Tax on unrelated business income and certain other activities.*—An organization exempt from taxation under subsection (a) shall be subject to tax to the extent provided in parts II, III, and VI of this subchapter, but (notwithstanding parts II, III, and VI of this subchapter) shall be considered an organization exempt from income taxes for the purpose of any law which refers to organizations exempt from income taxes.

(c) *List of exempt organizations.*—The following organizations are referred to in subsection (a):

(1) Corporations organized under Act of Congress, if such corporations are instrumentalities of the United States and if, under such Act, as amended and supplemented, such corporations are exempt from Federal income taxes.

(2) Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section.

(3) Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private

shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office.

(4) Civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

(5) Labor, agricultural, or horticultural organizations.

(6) Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(7) Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

(8) Fraternal beneficiary societies, orders, or associations—

(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or

other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual.

(10) Domestic fraternal societies, orders, or associations, operating under the lodge system—

(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

(B) which do not provide for the payment of life, sick, accident, or other benefits.

(11) Teachers' retirement fund associations of a purely local character, if—

(A) no part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and

(B) the income consists solely of amounts received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect of investments.

(12) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses. In the case of any mutual or cooperative telephone company, the preceding sentence shall be applied without taking into account any income received or accrued from a nonmember telephone company for the performance of communication services which involve members of such mutual or cooperative telephone company.

(13) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for the purpose of the disposal of bodies by

burial or cremation which is not permitted by its charter to engage in any business not necessarily incident to that purpose and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(14)(A) Credit unions without capital stock organized and operated for mutual purposes and without profit.

(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit, or

(iii) mutual savings banks not having capital stock represented by shares.

(C) Corporations or associations organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of subparagraph (B); but only if 85 percent or more of the income is attributable to providing such reserve funds and to investments. This subparagraph shall not apply to any corporation or association entitled to exemption under subparagraph (B).

(15) Mutual insurance companies or associations other than life or marine (including inter-insurers and reciprocal underwriters) if the gross amount received during the taxable year from the items described in section 822(b) (other than paragraph (1)(D) thereof) and premiums (including deposits and assessments) does not exceed $150,000.

(16) Corporations organized by an association subject to part IV of this subchapter or members there-

of, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, on dissolution or otherwise, beyond the fixed dividends) is owned by such associatin, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(17)(A) A trust or trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits, if—

(i) under the plan, it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the plan, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of supplemental unemployment compensation benefits,

(ii) such benefits are payable to employees under a classification which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees, and

(iii) such benefits do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compen-

sated employees. A plan shall not be considered discriminatory within the meaning of this clause merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan.

(B) In determining whether a plan meets the requirements of subparagraph (A), any benefits provided under any other plan shall not be taken into consideration, except that a plan shall not be considered discriminatory—

(i) merely because the benefits under the plan which are first determined in a nondiscriminatory manner within the meaning of subparagraph (A) are then reduced by any sick, accident, or unemployment compensation benefits received under State or Federal law (or reduced by a portion of such benefits if determined in a nondiscriminatory manner), or

(ii) merely because the plan provides only for employees who are not eligible to receive sick, accident, or unemployment compensation benefits under State or Federal law the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such laws if such employees were eligible for such benefits, or

(iii) merely because the plan provides only for employees who are not eligible under another plan (which meets the requirements of subparagraph (A)) of supplemental unemployment compensation benefits provided wholly by the employer the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such other plan, but only if the employees eligible under both plans would make a classification which would be nondiscriminatory within the meaning of subparagraph (A).

(C) A plan shall be considered to meet the requirements of subparagraph (A) during the whole of any year of the plan if on one day in each quarter it satisfies such requirements.

(D) The term "supplemental unemployment compensation benefits" means only—

(i) benefits which are paid to an employee because of his involuntary separation from the employment of the employer (whether or not such separation is temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and

(ii) sick and accident benefits subordinate to the benefits described in clause (i).

(E) Exemption shall not be denied under subsection (a) to any organization entitled to such exemption as an association described in paragraph (9) of this subsection merely because such organization provides for the payment of supplemental unemployment benefits (as defined in subparagraph (D)(i)).

(18) A trust or trusts created before June 25, 1959, forming a part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees, if—

(A) under the plan, it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the plan, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of benefits under the plan,

(B) such benefits are payable to employees under a classification which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees, and

(C) such benefits do not discriminate in favor of employees who are officers, shareholders, persons whose principal duties consist of supervising the work of other employees, or highly compensated employees. A plan shall not be considered discriminatory within the meaning of this subparagraph merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan.

(19) A post or organization of war veterans, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization—

(A) organized in the United States or any of its possessions,

(B) at least 75 percent of the members of which are war veterans and substantially all of the other members of which are individuals who are veterans (but not war veterans), or are cadets, or are spouses, widows, or widowers of war veterans or such individuals, and

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(20) an organization or trust created or organized in the United States, the exclusive function of which is to form a part of a qualified group legal services plan or plans, within the meaning of section 120. An organization or trust which receives contributions because of section 120(c) (5) (C) shall not be prevented from qualifying as an organization described in this paragraph merely because it provides legal services or indemnification against the cost of legal services unassociated with a qualified group legal services plan.

(21) a trust or trusts established in writing, created or organized in the United States, and contributed to by any person (except an insurance company) if—

(A) the purpose of such trust or trusts is exclusively—

(i) to satisfy, in whole or in part, the liability of such person for, or with respect to, claims for compensation for disability or death due to pneumoconiosis under Black Lung Acts;

(ii) to pay premiums for insurance exclusively covering such liability; and

(iii) to pay administrative and other incidental expenses of such trust (including legal, accounting, actuarial, and trustee expenses) in connection with the operation of the trust and the processing of claims against such person under Black Lung Acts, and

(B) no part of the assets of the trust may be used for, or diverted to, any purpose other than—

(i) the purposes described in subparagraph (A), or

(ii) investment (but only to the extent that the trustee determines that a portion of the assets is not currently needed for the purposes described in subparagraph (A)) in—

(I) public debt securities of the United States,

(II) obligations of a State or local government which are not in default as to principal or interest, or

(III) time or demand deposits in a bank (as defined in section 581) or an insured credit union (within the meaning of section 101(6) of the Federal Credit Union Act, 12 U.S.C. 1752(6)) located in the United States, or

(iii) payment into the Black Lung Disability Trust Fund established under section 3 of the Black Lung Benefits Revenue Act of 1977, or into the general fund of the United States Treasury (other than in satisfaction of any tax or other civil or criminal liability of the person who established or contributed to the trust).

For purposes of this paragraph the term "Black Lung Acts" means part C of title IV of the Federal Coal Mine Health and Safety Act of 1969, and any State law providing compensation for disability or death due to pneumoconiosis.

(d) *Religious and apostolic organizations.*—The following organizations are referred to in subsection (a): Religious or apostolic associations or corporations, if such associations or corporations have a common treasury or community treasury, even if such associations or corporations engage in business for the common benefit of the members, but only if the members thereof include (at the time of filing their returns) in their gross income their entire pro rata shares, whether distributed or not, of the taxable income of the association or corporation for such year. Any amount so included in the gross income of a member shall be treated as a dividend received.

(e) *Cooperative hospital service organizations.*—For purposes of this title, an organization shall be treated as an organization organized and operated exclusively for charitable purposes, if—

(1) such organization is organized and operated solely—

(A) to perform, on a centralized basis, one or more of the following services which, if performed on its own behalf by a hospital which is an organization described in subsection (c)(3) and exempt from taxation under subsection (a), would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption: data processing, purchasing, warehousing, billing and collection, food, clinical, industrial engineering, laboratory, printing, communications, record center, and personnel (including selection, testing, training, and education of personnel) services; and

(B) to perform such services solely for two or more hospitals each of which is—

(i) an organization described in subsection (c) (3) which is exempt from taxation under subsection (a).

(ii) a constituent part of an organization described in subsection (c) (3) which is exempt from taxation under subsection (a) and which, if organized and operated as a separate entity, would constitute an organization described in subsection (c) (3), or

(iii) owned and operated by the United States, a State, the District of Columbia, or a possession of the United States, or a political subdivision or an agency or instrumentality of any of the foregoing;

(2) such organization is organized and operated on a cooperative basis and allocates or pays, within 8½ months after the close of its taxable year, all net earnings to patrons on the basis of services performed for them; and

(3) if such organization has capital stock, all of such stock outstanding is owned by its patrons.

For purposes of this title, any organization which, by reason of the preceding sentence, is an organization described in subsection (c) (3) and exempt from taxation under subsection (a), shall be treated as a hospital and as an organization referred to in section 170(b) (1)(A) (iii).

(f) *Cooperative service organizations of operating educational organizations.*—For purposes of this title, if an organization is—

(1) organized and operated solely to hold, commingle, and collectively invest and reinvest (including arranging for and supervising the performance by independent contractors of investment services related thereto) in stocks and securities, the moneys contributed thereto by each of the members of such organization, and to collect income therefrom and turn over the entire amount thereof, less expenses, to such members,

(2) organized and controlled by one or more such members, and

(3) comprised solely of members that are organizations described in clause (ii) or (iv) of section 170(b)(1)(A)—

(A) which are exempt from taxation under subsection (a), or

(B) the income of which is excluded from taxation under section 115(a),

then such organization shall be treated as an organization organized and operated exclusively for charitable purposes.

(g) *Definition of agricultural.*—For purposes of subsection (c)(5), the term "agricultural" includes the art or science of cultivating land, harvesting crops or aquatic resources, or raising livestock.

(h) *Expenditures by public charities to influence legislation.*—

(1) *General rule.*—In the case of an organization to which this subsection applies, exemption from taxation under subsection (a) shall be denied because a substantial part of the activities of such organization consists of carrying on propaganda, or otherwise attempting, to influence legislation, but only if such organization normally—

(A) makes lobbying expenditures in excess of the lobbying ceiling amount for such organization for each taxable year, or

(B) makes grass roots expenditures in excess of the grass roots ceiling amount for such organization for each taxable year.

(2) *Definitions.*—For purposes of this subsection—

(A) *Lobbying expenditures.*—The term "lobbying expenditures" means expenditures for the purpose of influencing legislation (as defined in section 4911(d)).

(B) *Lobbying ceiling amount.*—The lobbying ceiling amount for any organization for any tax-

able year is 150 percent of the lobbying nontaxable amount for such organization for such taxable year, determined under section 4911.

(C) *Grass roots expenditures.*—The term "grass roots expenditures" means expenditures for the purpose of influencing legislation (as defined in section 4911(d) without regard to paragraph (1) (B) thereof).

(D) *Grass roots ceiling amount.*—The grass roots ceiling amount for any organization for any taxable year is 150 percent of the grass roots nontaxable amount for such organization for such taxable year, determined under section 4911.

(3) *Organizations to which this subsection applies.*—This subsection shall apply to any organization which has elected (in such manner and at such time as the Secretary may prescribe) to have the provisions of this subsection apply to such organization and which, for the taxable year which includes the date the election is made, is described in subsection (c) (3) and—

(A) is described in paragraph (4), and

(B) is not a disqualified organization under paragraph (5).

(4) *Organizations permitted to elect to have this subsection apply.*—An organization is described in this paragraph if it is described in—

(A) section 170(b) (1) (A) (ii) (relating to educational institutions),

(B) section 170(b) (1) (A) (iii) (relating to hospitals and medical research organizations),

(C) section 170(b) (1) (A) (iv) (relating to organizations supporting government schools),

(D) section 170(b) (1) (A) (vi) (relating to organizations publicly supported by charitable contributions),

(E) section 509(a) (2) (relating to organizations publicly supported by admissions, sales, etc.), or

(F) section 509(a) (3) (relating to organizations supporting certain types of public charities) except that for purposes of this subparagraph, section 509(a) (3) shall be applied without regard to the last sentence of section 509(a).

(5) *Disqualified organizations.*—For purposes of paragraph (3) an organization is a disqualified organization if it is—

(A) described in section 170(b) (1) (A) (i) (relating to churches),

(B) an integrated auxiliary of a church or of a convention or association of churches, or

(C) a member of an affiliated group of organizations (within the meaning of section 4911(f) (2)) if one or more members of such group is described in subparagraph (A) or (B).

(6) *Years for which election is effective.*—An election by an organization under this subsection shall be effective for all taxable years of such organization which—

(A) end after the date the election is made, and

(B) begin before the date the election is revoked by such organization (under regulations prescribed by the Secretary).

(7) *No effect on certain organizations.*—With respect to any organization for a taxable year for which—

(A) such organization is a disqualified organization (within the meaning of paragraph (5)), or

(B) an election under this subsection is not in effect for such organization,

nothing in this subsection or in section 4911 shall be construed to affect the interpretation of the phrase, "no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation," under subsection (c) (3).

(8) *Affiliated organizations.*—

For rules regarding affiliated organizations, see section 4911(f).

(i) *Prohibition of discrimination by certain social clubs.*—Notwithstanding subsection (a), an organization which is described in subsection (c) (7) shall not be exempt from taxation under subsection (a) for any taxable year if, at any time during such taxable year, the charter, bylaws, or other governing instrument, of such organization or any written policy statement of such organization contains a provision which provides for discrimination against any person on the basis of race, color, or religion.

(j) *Cross reference.*—

For nonexemption of Communist-controlled organizations, see section 11(b) of the Internal Security Act of 1950 (64 Stat. 997; 50 U.S.C. 790(b)).

Aug. 16, 1954, c. 736, 68A Stat. 163; Mar. 13, 1956, c. 83, § 5(2), 70 Stat. 49; Apr. 22, 1960, Pub.L. 86-428, § 1, 74 Stat. 54; July 14, 1960, Pub.L. 86-667, § 1, 74 Stat. 534; Oct. 16, 1962, Pub.L. 87-834, §8(d), 76 Stat. 997; Feb. 2, 1966, Pub. L. 89-352, § 1, 80 Stat. 4; Nov. 8, 1966, Pub. L. 89-800, § 6(a), 80 Stat. 1515; June 28, 1968, Pub. L. 90-364, Title I, § 109(a), 82 Stat. 269; Dec. 30, 1969, Pub.L. 91-172, Title I, §§ 101(j) (3)-(6), 121(b) (5) (A), (6) (A), 83 Stat. 526, 527, 541; Dec. 31, 1970, Pub.L. 91-618, § 1, 84 Stat. 1855; Aug. 29, 1972, Pub.L. 92-418, § 1(a), 86 Stat. 656; June 8, 1974, Pub.L. 93-310, § 3(a), 88 Stat. 235; Jan. 3, 1975, Pub. L. 93-625, § 10(c), 88 Stat. 2119; Oct. 4, 1976, Pub.L. 94-455, Title XIII, §§ 1307(a) (1), (d) (1) (A), 1312(a), 1313 (a), Title XIX, § 1906(b) (13) (A), Title XXI, §§ 2113(a), 2134(b), 90 Stat. 1720, 1727, 1730, 1834, 1907, 1927; Oct. 20, 1976, Pub.L. 94-568, §§ 1(a), 2(a), 90 Stat. 2697; Feb. 10, 1978, Pub.L. 95-227, § 4(a), 92 Stat. 15; Aug. 15, 1978, Pub. L. 95-345, § 1(a), 92 Stat. 481; Nov. 6, 1978, Pub.L. 95-600, Title VII, § 703(b) (2), (g) (2) (B), 92 Stat. 2939, 2940.

§ 504. Denial of exemption

(a) *General rule.*—In the case of any organization described in section 501(c) (3) to which section 503 is applicable, exemption under section 501 shall be denied for the taxable year if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(2) are used to a substantial degree for purposes or functions other than those constituting the basis for exemption under section 501 (a) of an organization described in section 501 (c) (3); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for exemption under section 501 (a) of an organization described in section 501(c) (3).

Paragraph (1) shall not apply to income attributable to property of a decedent dying before January 1, 1951, which is transferred under his will to a trust created by such will. In the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, paragraph (1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument.

(b) *Cross references.*—

For limitation on charitable contributions in case of unreasonable accumulations by certain trusts, see section 681 (c) (2).

§ 511. Imposition of tax on unrelated business income of charitable, etc., organizations

(a) *Charitable, etc., organizations taxable at corporation rates.*

(1) *Imposition of tax.*—There is hereby imposed for each taxable year on the unrelated business taxable income (as defined in section 512) of every organization described in paragraph (2) a tax computed as provided in section 11. In making such computation for purposes of this section, the term "taxable income" as used in section 11 shall be read as "unrelated business taxable income".

(2) *Organizations subject to tax.*—

(A) *Organizations described in sections 401 (a) and 501 (c).*—The tax imposed by paragraph (1) shall apply in the case of any organization (other than a trust described in subsection (b) or an organization described in section 501(c) (1)) which is exempt, except as provided in this part or part II (relating to private foundations), from taxation under this subtitle by reason of section 501(a).

(B) *State colleges and universities.*—The tax imposed by paragraph (1) shall apply in the case of any college or university which is an agency or instrumentality of any government or any political subdivision thereof, or which is owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions. Such tax shall also apply in the case of any corporation wholly owned by one or more such colleges or universities.

(b) *Tax on charitable, etc., trusts.*—

(1) *Imposition of tax.*—There is hereby imposed for each taxable year on the unrelated business taxable income of every trust described in paragraph (2) a

tax computed as provided in section 1(e). In making such computation for purposes of this section, the term "taxable income" as used in section 1 shall be read as "unrelated business taxable income" as defined in section 512.

(2) *Charitable, etc., trusts subject to tax.*—The tax imposed by paragraph (1) shall apply in the case of any trust which is exempt, except as provided in this part or part II (relating to private foundations) from taxation under this subtitle by reason of section 501 (a) and which, if it were not for such exemption, would be subject to subchapter J (sec. 641 and following, relating to estates, trusts, beneficiaries, and decedents).

(c) *Special rule for section 501(c) (2) corporations.*—

If a corporation described in section 501(c) (2)—

(1) pays any amount of its net income for a taxable year to an organization exempt from taxation under section 501(a) (or which would pay such an amount but for the fact that the expenses of collecting its income exceed its income), and

(2) such corporation and such organization file a consolidated return for the taxable year,

such corporation shall be treated, for purposes of the tax imposed by subsection (a), as being organized and operated for the same purposes as such organization, in addition to the purposes described in section 501(c) (2).

(d) *Tax preferences.*—

(1) *Organizations taxable at corporate rates.*—If an organization is subject to tax on unrelated business taxable income pursuant to subsection (a), the tax imposed by section 56 shall apply to such organizations with respect to items of tax preference which enter into the computation of unrelated business taxable income in the same manner as section 56 applies to corporations.

(2) *Organizations taxable as trusts.*—If an organization is subject to tax on unrelated business taxable income pursuant to subsection (b), then taxes imposed by section 55 and section 56 (as the case may be) shall apply to such organization with respect to items of tax preference which enter into the computation of unrelated business taxable income.

Aug. 16, 1954, c. 736, 68A Stat. 169; July 14, 1960, Pub.L. 86-667, § 3, 74 Stat. 535; Feb. 2, 1966, Pub.L. 89-352, § 2, 80 Stat. 4; Dec. 30, 1969, Pub.L. 91-172, Title I, § 121(a) (1)-(3), Title III, § 301(b) (8), Title VIII, § 803(d) (2), 83 Stat. 536, 585, 684; May 23, 1977, Pub.L. 95-30, Title I, § 101(d) (6), 91 Stat. 133; Nov. 6, 1978, Pub.L. 95-600, Title III, § 301(b) (5), Title IV, § 421(e) (3), 92 Stat. 2821, 2876.

§ 512. Unrelated business taxable income

(a) *Definition.*—For purposes of this title—

(1) *General rule.*—Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

(2) *Special rule for foreign organizations.*—In the case of an organization described in section 511 which is a foreign organization, the unrelated business taxable income shall be—

(A) its unrelated business taxable income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, plus

(B) its unrelated business taxable income which is effectively connected with the conduct of a trade or business within the United States.

(3) *Special rules applicable to organizations described in section 501(c) (7) or (9).*—

(A) *General rule.*—In the case of an organization described in section 501(c) (7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11), and (12) of subsection (b). For purposes of the preceding sentence, the deductions provided by sections 243, 244, and 245 (relating to dividends received by

corporations) shall be treated as not directly connected with the production of gross income.

(B) *Exempt function income.*—For purposes of subparagraph (A), the term "exempt function income" means the gross income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members or their dependents or guests goods, facilities, or services in furtherance of the purposes constituting the basis for the exemption of the organization to which such income is paid. Such term also means all income (other than an amount equal to the gross income derived from any unrelated trade or business regularly carried on by such organization computed as if the organization were subject to paragraph (1)), which is set aside—

(i) for a purpose specified in section 170 (c) (4), or

(ii) in the case of an organization described in section 501(c) (9), to provide for the payment of life, sick, accident, or other benefits,

including reasonable costs of administration directly connected with a purpose described in clause (i) or (ii). If during the taxable year, an amount which is attributable to income so set aside is used for a purpose other than that described in clause (i) or (ii), such amount shall be included, under subparagraph (A), in unrelated business taxable income for the taxable year.

(C) *Applicability to certain corporations described in section 501(c) (2).*—In the case of a corporation described in section 501(c) (2), the income of which is payable to an organization described in section 501(c) (7) or (9), subparagraph (A) shall apply as if such corporation were the organization to which the income is payable. For

purposes of the preceding sentence, such corporation shall be treated as having exempt function income for a taxable year only if it files a consolidated return with such organization for such year.

(D) *Nonrecognition of gain.*—If property used directly in the performance of the exempt function of an organization described in section 501(c) (7) or (9) is sold by such organization, and within a period beginning 1 year before the date of such sale, and ending 3 years after such date, other property is purchased and used by such organization directly in the performance of its exempt function, gain (if any) from such sale shall be recognized only to the extent that such organization's sales price of the old property exceeds the organization's cost of purchasing the other property. For purposes of this subparagraph, the destruction in whole or in part, theft, seizure, requisition, or condemnation of property, shall be treated as the sale of such property, and rules similar to the rules provided by subsections (b), (c), (e), and (j) of section 1034 shall apply.

(4) *Special rule applicable to organizations described in section 501(c) (19).*—In the case of an organization described in section 501(c) (19), the term "unrelated business taxable income" does not include any amount attributable to payments for life, sick, accident, or health insurance with respect to members of such organizations or their dependents which is set aside for the purpose of providing for the payment of insurance benefits or for a purpose specified in section 170(c) (4). If an amount set aside under the preceding sentence is used during the taxable year for a purpose other than a purpose described in the preceding sentence, such amount shall be included, under paragraph (1), in unrelated business taxable income for the taxable year.

(5) *Definition of payments with respect to securities loans.*—

(A) The term "payments with respect to securities loans" includes all amounts received in respect of a security (as defined in section 1236 (c)) transferred by the owner to another person in a transaction to which section 1058 applies (whether or not title to the security remains in the name of the lender) including—

(i) amounts in respect of dividends, interest, or other distributions,

(ii) fees computed by reference to the period beginning with the transfer of securities by the owner and ending with the transfer of identical securities back to the transferor by the transferee and the fair market value of the security during such period,

(iii) income from collateral security for such loan, and

(iv) income from the investment of collateral security.

(B) Subparagraph (A) shall apply only with respect to securities transferred pursuant to an agreement between the transferor and the transferee which provides for—

(i) reasonable procedures to implement the obligation of the transferee to furnish to the transferor, for each business day during such period, collateral with a fair market value not less than the fair market value of the security at the close of business on the preceding business day,

(ii) termination of the loan by the transferor upon notice of not more than 5 business days, and

(iii) return to the transferor of securities identical to the transferred securities upon termination of the loan.

(b) *Modifications.* The modifications referred to in subsection (a) are the following:

(1) There shall be excluded all dividends, interest, payments with respect to securities loans (as defined in section 512(a) (5)), and annuities, and all deductions directly connected with such income.

(2) There shall be excluded all royalties (including overriding royalties) whether measured by production or by gross or taxable income from the property, and all deductions directly connected with such income.

(3) In the case of rents—

(A) Except as provided in subparagraph (B), there shall be excluded—

(i) all rents from real property (including property described in section 1245(a) (3) (C)), and

(ii) all rents from personal property including for purposes of this paragraph as personal property any property described in section 1245(a) (3) (B)) leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

(B) Subparagraph (A) shall not apply—

(i) if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property described in subparagraph (A) (ii), or

(ii) if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage or percentages of receipts or sales).

(C) There shall be excluded all deductions directly connected with rents excluded under subparagraph (A).

(4) Notwithstanding paragraph (1), (2), (3), or (5), in the case of debt-financed property (as defined in section 514) there shall be included, as an item of gross income derived from an unrelated trade or business, the amount ascertained under section 514(a) (1), and there shall be allowed, as a deduction, the amount ascertained under section 514(a) (2).

(5) There shall be excluded all gains or losses from the sale, exchange, or other disposition of property other than—

(A) stock in trade or other property of a kind which would properly be includible in inventory if on hand at the close of the taxable year, or

(B) property held primarily for sale to customers in the ordinary course of the trade or business.

There shall also be excluded all gains on the lapse or termination of options, written by the organization in connection with its investment activities, to buy or sell securities (as defined in Section 1236(c)). This paragraph shall not apply with respect to the cutting of timber which is considered, on the application of section 631, as a sale or exchange of such timber.

(6) The net operating loss deduction provided in section 172 shall be allowed, except that—

(A) the net operating loss for any taxable year, the amount of the net operating loss carryback or carryover to any taxable year, and the net operating loss deduction for any taxable year shall be determined under section 172 without taking into account any amount of income or deduction which is excluded under this part in computing the unrelated business taxable income; and

(B) the terms "preceding taxable year" and "preceding taxable years" as used in section 172 shall not include any taxable year for which the

organization was not subject to the provisions of this part.

(7) There shall be excluded all income derived from research for (A) the United States, or any of its agencies or instrumentalities, or (B) any State or political subdivision thereof; and there shall be excluded all deductions directly connected with such income.

(8) In the case of a college, university, or hospital, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(9) In the case of an organization operated primarily for purposes of carrying on fundamental research the results of which are freely available to the general public, there shall be excluded all income derived from research performed for any person, and all deductions directly connected with such income.

(10) In the case of any organization described in section 511(a), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), but shall not exceed 5 percent of the unrelated business taxable income computed without the benefit of this paragraph.

(11) In the case of any trust described in section 511(b), the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed within the limitations prescribed in section 170(b) (1) (A) and (B) determined with reference to the unrelated business taxable in-

come computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

(12) Except for purposes of computing the net operating loss under section 172 and paragraph (6), there shall be allowed a specific deduction of $1,000. In the case of a diocese, province of a religious order, or a convention or association of churches, there shall also be allowed, with respect to each parish, individual church, district, or other local unit, a specific deduction equal to the lower of—

(A) $1,000, or

(B) the gross income derived from any unrelated trade or business regularly carried on by such local unit.

(13) Notwithstanding paragraphs (1), (2), or (3), amounts of interest, annuities, royalties, and rents derived from any organization (in this paragraph called the "controlled organization") of which the organization deriving such amounts (in this paragraph called the "controlling organization") has control (as defined in section 368(c)) shall be included as an item of gross income (whether or not the activity from which such amounts are derived represents a trade or business or is regularly carried on) in an amount which bears the same ratio as—

(A) (i) in the case of a controlled organization which is not exempt from taxation under section 501(a), the excess of the amount of taxable income of the controlled organization over the amount of such organization's taxable income which if derived directly by the controlling organization would not be unrelated business taxable income, or

(ii) in the case of a controlled organization which is exempt from taxation under section 501(a), the amount of unrelated business taxable income of the controlled organization, bears to

(B) the taxable income of the controlled organization (determined in the case of a controlled

organization to which subparagraph (A) (ii) applies as if it were not an organization exempt from taxation under section 501(a)), but not less than the amount determined in clause (i) or (ii), as the case may be, of subparagraph (A),

both amounts computed without regard to amounts paid directly or indirectly to the controlling organization. There shall be allowed all deductions directly connected with amounts included in gross income under the preceding sentence.

(14) Except as provided in paragraph (4), in the case of a church, or convention or association of churches, for taxable years beginning before January 1, 1976, there shall be excluded all gross income derived from a trade or business and all deductions directly connected with the carrying on of such trade or business if such trade or business was carried on by such organization or its predecessor before May 27, 1969.

(15) Except as provided in paragraph (4), in the case of a trade or business—

(A) which consists of providing services under license issued by a Federal regulatory agency,

(B) which is carried on by a religious order or by an educational organization described in section 170(b) (1) (A) (ii) maintained by such religious order, and which was so carried on before May 27, 1959, and

(C) less than 10 percent of the net income of which for each taxable year is used for activities which are not related to the purpose constituting the basis for the religious order's exemption,

there shall be excluded all gross income derived from such trade or business and all deductions directly connected with the carrying on of such trade or business, so long as it is established to the satisfaction of the Secretary that the rates or other charges for such

services are competitive with rates or other charges charged for similar services by persons not exempt from taxation.

(c) *Special rules applicable to partnerships.*—If a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business taxable income shall, subject to the exceptions, additions, and limitations contained in subsection (b), include its share (whether or not distributed) of the gross income of the partnership from such unrelated trade or business and its share of the partnership deductions directly connected with such gross income. If the taxable year of the organization is different from that of the partnership, the amounts to be so included or deducted in computing the unrelated business taxable income shall be based upon the income and deductions of the partnership for any taxable year of the partnership ending within or with the taxable year of the organization.

Aug. 16, 1954, c. 736, 68A Stat. 170; Apr. 7, 1958, Pub.L. 85-367, § 1(a), 72 Stat. 80; July 17, 1964, Pub.L. 88-380, § 1, 78 Stat. 333; Nov. 13, 1966, Pub.L. 89-809, Title I, § 104 (g), 80 Stat. 1559; Dec. 30, 1969, Pub.L. 9-172, Title I, § 121(b) (1), (2), 83 Stat. 537, 538; Aug. 29, 1972, Pub.L. 92-418, § 1(b), 86 Stat. 656; Sept. 3, 1976, Pub.L. 94-396, § 1(a), 90 Stat. 1201; Oct. 4, 1976, Pub.L. 94-455, Title XIX, §§ 1091(b) (8) (F), 1906(b) (13) (A), 1951(b) (8) (A), 90 Stat. 1794, 1834, 1839; Oct. 20, 1976, Pub.L. 94-568, § 1 (b), 90 Stat. 2697; Aug. 15, 1978, Pub.L. 95-345, §2(a) (2), (b), 92 Stat. 481.

§ 513. Unrelated trade or business

(a) *General rule.*—The term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or, in the case of an organization described in section 511(a) (2) (B), to the exercise or performance of any purpose or function described in section 501(c) (3)), except that such term does not include any trade or business—

(1) in which substantially all the work in carrying on such trade or business is performed for the organization without compensation; or

(2) which is carried on, in the case of an organization described in section 501(c) (3) or in the case of a college or university described in section 511(a) (2) (B), by the organization primarily for the convenience of its members, students, patients, officers, or employees, or, in the case of a local association of employees described in section 501(c) (4) organized before May 27, 1969, which is the selling by the organization of items of work-related clothes and equipment and items normally sold through vending machines, through food dispensing facilities, or by snack bars, for the convenience of its members at their usual places of employment; or

(3) which is the selling of merchandise, substantially all of which has been received by the organization as gifts or contributions.

(b) *Special rule for trusts.*—The term "unrelated trade or business" means, in the case of—

(1) a trust computing its unrelated business taxable income under section 512 for purposes of section 681; or

(2) a trust described in section 401(a), or section 501(c) (17), which is exempt from tax under section 501(a);

any trade or business regularly carried on by such trust or by a partnership of which it is a member.

(c) *Advertising, etc., activities.*—For purposes of this section, the term "trade or business" includes any activity which is carried on for the production of income from the sale of goods or the performance of services. For purposes of the preceding sentence, an activity does not lose identity as a trade or business merely because it is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors which may, or may not, be related to the exempt purposes of the organization. Where an activity carried on for profit constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

(d) *Certain activities of trade shows, state fairs, etc.*—

(1) *General rule.*—The term "unrelated trade or business" does not include qualified public entertainment activities of an organization described in paragraph (2) (C), or qualified convention and trade show activities of an organization described in paragraph (3) (C).

(2) *Qualified public entertainment activities.*—For purposes of this subsection—

(A) *Public entertainment activity.*—The term "public entertainment activity" means any entertainment or recreational activity of a kind traditionally conducted at fairs or expositions promoting agricultural and educational purposes, including, but not limited to, any activity one of the purposes of which is to attract the public to fairs or expositions or to promote the breeding of animals or the development of products or equipment.

(B) *Qualified public entertainment activity.*—The term "qualified public entertainment activity" means a public entertainment activity which is conducted by a qualifying organization described in subparagraph (C) in—

(i) conjunction with an international, national, State, regional, or local fair or exposition,

(ii) accordance with the provisions of State law which permit the activity to be operated or conducted solely by such an organization, or by an agency, instrumentality, or political subdivision of such State, or

(iii) accordance with the provisions of State law which permit such an organization to be granted a license to conduct not more than 20 days of such activity on payment to the State of a lower percentage of the revenue from such licensed activity than the State requires from organizations not described in section 501(c) (3), (4), or (5).

(C) *Qualifying organization.*—For purposes of this paragraph, the term "qualifying organization" means an organization which is described in section 501(c) (3), (4), or (5) which regularly conducts, as one of its substantial exempt purposes, an agricultural and educational fair or exposition.

(3) *Qualified convention and trade show activities.*—

(A) *Convention and trade show activity.*—The term "convention and trade show activity" means any activity of a kind traditionally conducted at conventions, annual meetings, or trade shows, including, but not limited to, any activity one of the purposes of which is to attract persons in an industry generally (without regard to membership in the sponsoring organization) as well as members of the public to the show for the purpose

of displaying industry products or to stimulate interest in, and demand for, industry products or services, or to educate persons engaged in the industry in the development of new products and services or new rules and regulations affecting the industry.

(B) *Qualified convention and trade show activity.*—The term "qualified convention and trade show activity" means a convention and trade show activity carried out by a qualifying organization described in subparagraph (C) in conjunction with an international, national, State, regional, or local convention, annual meeting, or show conducted by an organization described in subparagraph (C) if one of the purposes of such organization in sponsoring the activity is the promotion and stimulation of interest in, and demand for, the products and services of that industry in general, and the show is designed to achieve such purpose through the character of the exhibits and the extent of the industry products displayed.

(C) *Qualifying organization.*—For purposes of this paragraph, the term "qualifying organization" means an organization described in section 501(c) (5) or (6) which regularly conducts as one of its substantial exempt purposes a show which stimulates interest in, and demand for, the products of a particular industry or segment of such industry.

(4) *Such activities not to affect exempt status.*—An organization described in section 501(c) (3), (4), or (5) shall not be considered as not entitled to the exemption allowed under section 501(a) solely because of qualified public entertainment activities conducted by it.

(e) *Certain hospital services.*—In the case of a hospital described in section 170(b) (1) (A) (iii), the term "unrelated trade or business" does not include the furnishing

of one or more of the services described in section 501(e)
(1) (A) to one or more hospitals described in section 170
(b) (1) (A) (iii) if—

(1) such services are furnished solely to such hospitals which have facilities to serve not more than 100 inpatients;

(2) such services, if performed on its own behalf by the recipient hospital, would constitute activities in exercising or performing the purpose or function constituting the basis for its exemption; and

(3) such services are provided at a fee or cost which does not exceed the actual cost of providing such services, such cost including straight line depreciation and a reasonable amount for return on capital goods used to provide such services.

(f) *Certain bingo games.*—

(1) *In general.*—The term "unrelated trade or business" does not include any trade or business which consists of conducting bingo games.

(2) *Bingo game defined.*—For purposes of paragraph (1), the term "bingo game" means any game of bingo—

(A) of a type if which usually—

(i) the wagers are placed,

(ii) the winners are determined, and

(iii) the distribution of prizes or other property is made, in the presence of all persons placing wagers in such game.

(B) the conducting of which is not an activity ordinarily carried out on a commercial basis, and

(C) the conducting of which does not violate any State or local law.

Aug. 16, 1954, c. 736, 68A Stat. 172; July 14, 1960, Pub.L. 86-667, § 4, 74 Stat. 536; Dec. 30, 1969, Pub.L. 91-172, Title I, § 121(b) (4), (c), 83 Stat. 541, 542; Oct. 4, 1976, Pub.L. 94-455, Title XIII, §§ 1305(a), 1311(a), 90 Stat. 1716, 1729; Oct. 21, 1978, Pub.L. 95-502, Title III, § 301(a), 92 Stat. 1702.

EXCERPTS FROM TREASURY REGULATIONS (1959)

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§ 1.1501(c)(3)-1. Organizations organized and operated for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or for the prevention of cruelty to children or animals

(a) *Organizational and operational tests.* (1) In order to be exempt as an organization described in section 501(c) (3), an organization must be both organized and operated exclusively for one or more of the purposes specified in such section. If an organization fails to meet either the organizational test or the operational test, it is not exempt.

(2) The term "exempt purpose or purposes", as used in this section, means any purpose or purposes specified in section 501(c) (3), as defined and elaborated in paragraph (d) of this section.

(b) *Organizational test*—(1) *In general.* (i) An organization is organized exclusively for one or more exempt purposes only if its articles of organization (referred to in this section as its "articles") as defined in subparagraph (2) of this paragraph:

(a) Limit the purpose of such organization to one or more exempt purposes; and

(b) Do not expressly empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.

(ii) In meeting the organizational test, the organization's purposes, as stated in its articles, may be as broad as, or more specific than, the purposes stated in section 501(c) (3). Therefore, an organization which, by the terms of its articles, is formed "for literary and scientific purposes within the meaning of section 501(c) (3) of the Code" shall, if it otherwise meets the requirements in this paragraph, be considered to have met the organiza-

tional test. Similarly, articles stating that the organization is created solely "to receive contributions and pay them over to organizations which are described in section 501 (c) (3) and exempt from taxation under section 501(a)" are sufficient for purposes of the organizational test. Moreover, it is sufficient if the articles set forth the purpose of the organization to be the operation of a school for adult education and describe in detail the manner of the operation of such school. In addition, if the articles state that the organization is formed for "charitable purposes", such articles ordinarily shall be sufficient for purposes of the organizational test (see subparagraph (5) of this paragraph for rules relating to construction of terms).

(iii) An organization is not organized exclusively for one or more exempt purposes if its articles expressly empower it to carry on, otherwise than as an insubstantial part of its activities, activities which are not in furtherance of one or more exempt purposes, even though such organization is, by the terms of such articles, created for a purpose that is no broader than the purposes specified in section 501(c) (3). Thus, an organization that is empowered by its articles "to engage in a manufacturing business", or "to engage in the operation of a social club" does not meet the organizational test regardless of the fact that its articles may state that such organization is created "for charitable purposes within the meaning of section 501(c) (3) of the Code."

(iv) In no case shall an organization be considered to be organized exclusively for one or more exempt purposes, if, by the terms of its articles, the purposes for which such organization is created are broader than the purposes specified in section 501(c) (3). The fact that the actual operations of such an organization have been exclusively in furtherance of one or more exempt purposes shall not be sufficient to permit the organization to meet the organizational test. Similarly, such an organization will not meet the organizational test as a result of statements or other evidence that the members thereof intended to operate only in furtherance of one or more exempt purposes.

(v) An organization must, in order to establish its exemption, submit a detailed statement of its proposed activities with and as a part of its application for exemption (see paragraph (b) of § 1.501(a)-1).

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(c) *Operational test*—(1) *Primary activities.* An organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c) (3). An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

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(d) *Exempt purposes*—(1) *In general.* (i) An organization may be exempt as an organization described in section 501(c) (3) if it is organized and operated exclusively for one or more of the following purposes:

(a) Religious,
(b) Charitable,
(c) Scientific,
(d) Testing for public safety,
(e) Literary,
(e) Educational, or
(g) Prevention of cruelty to children or animals.

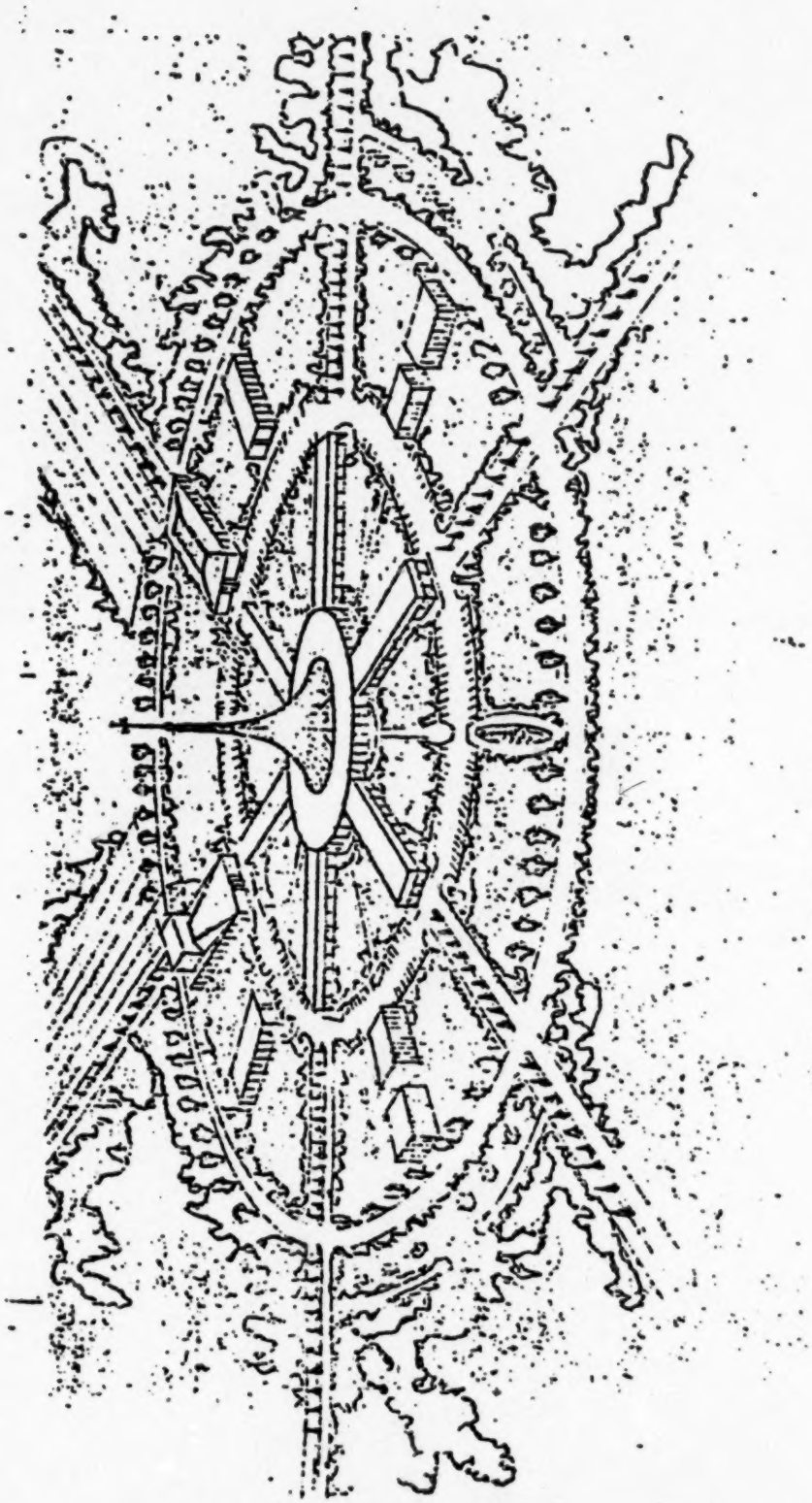
(ii) An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

(iii) Since each of the purposes specified in subdivision (i) of this subparagraph is an exempt purpose in itself, an organization may be exempt if it is organized and operated exclusvely for any one or more of such purposes.

If, in fact, an oganization is organized and operated exclusively for an exempt purpose or purposes, exemption will be granted to such an organization regardless of the purpose or purposes specified in its application for exemption. For example, if an organization claims exemption on the ground that it is "educational", exemption will not be denied if, in fact, it is "charitable".

(2) *Charitable defined.* The term "charitable" is used in section 501(c) (3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c) (3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such terms includes: Relief of the poor and distressed or of the underprivileged; advancement of religion, advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes. The fact that an organization, in carrying out its primary purpose, advocates social or civic changes or presents opinion on controversial issues with the intention of molding public opinion or creating public sentiment to an acceptance of its views does not preclude such organization from qualifying under section 501 (c) (3) so long as it is not an "action" organization of any one of the types described in paragraph (c) (3) of this section.

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• WESTERN CATHOLIC CHURCH • FOR DEAN FIGURE • MUSEUM • JOHN F. KENNEDY ARCHIVE •

No. 80-1049

CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1980

WESTERN CATHOLIC CHURCH, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The question presented in this federal income tax case is whether the Commissioner properly revoked petitioner's tax exempt status under Section 501(c)(3) of the Internal Revenue Code of 1954 (26 U.S.C.) on the grounds that it was not operated exclusively for exempt purposes and that part of its net income inured to the benefit of private individuals.

The pertinent facts may be summarized as follows: Petitioner[1] was incorporated in 1971 by S. Dean Slough and his wife and daughter. In its application for exemption from federal income tax, petitioner stated that its purpose was "to further religion and benefit mankind," and its proposed

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[1]Petitioner uses "Catholic" in its name in the lower-case sense of universal. Petitioner has no affiliation with the Roman Catholic Church or any similar organization (Pet. App. 4a-5a).

activities included the building of churches, colleges, nursing homes and a hospital. The application provided further that no single individual, group or organization would donate an amount exceeding ten percent of its assets, and that none of the officers or directors would be related by blood or marriage (Pet. App. 6a-7a, 10a). Based upon these representations, the Commissioner determined that petitioner met the requirements for exemption from federal income tax set under Section 501(c)(3). Contrary to the representations made in petitioner's exemption application, however, petitioner's only officers and directors during the taxable years at issue (1972-1974) were Slough and his wife and daughter. In addition, Slough himself donated and claimed a corresponding tax deduction for virtually all of petitioner's operating funds (Pet. App. 5a, 7a, 9a-10a, 24a).

Petitioner conducted no religious services or functions on a group basis during this period. Slough was petitioner's only minister, despite his lack of theological training (Pet. App. 7a), and he claimed that he spent about 10-12 hours per month talking with friends on a one-to-one basis in an attempt to get them to join the church.[2] Membership in the church required nothing more than an acceptance of petitioner's principles and an agreement to attend services when held in the future. Although Slough claimed that petitioner had 40 members, only Slough, his wife and daughter, and two individuals (one a longtime friend and the other a former employee) were identified as members (Pet. App. 8a).[3]

Petitioner's primary activity during these years was engaging in stock and real estate investments for the stated

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[2]Slough devoted his full-time attention to various business enterprises (Pet. App. 7a).

[3]The Tax Court determined that petitioner had only five members (Pet. App. 22a). Contrary to petitioner's assertion (Pet. 6), the government has never conceded that there were additional members.

purpose of accumulating money to build a church (Pet. App. 11a, 23a).[4] Petitioner obtained loans to finance many of these investments, often aided by Slough or his wholly-owned corporations. In addition, Slough occasionally borrowed money from petitioner for his own personal use (Pet. App. 15a).

During 1972, Slough wrote checks to cash from petitioner's bank account totalling $5,200. He testified that this money was donated to individuals personally known by him to be in need of financial assistance. Slough was able to identify only six recipients, however, who recieved a total of $3,875 (Pet. App. 8a-9a; R. 18; Tr. 54-55).[5] Petitioner also paid $1,600 to Slough's daughter (Pet. App. 27a).

On these facts, the Tax Court upheld the Commissioner's revocation of petitioner's tax-exempt status (Pet. App. 2a-28a). In the court's view, petitioner had not demonstrated that it was operated exclusively for religious purposes and that no part of its net earnings inured to the benefit of private individuals. As the Tax Court stated (Pet. App. 27a): "Petitioner was utilized by Slough as an 'incorporated pocketbook' into which he could transfer excess personal funds, claiming tax deductions, while he still retained complete control of the funds and used them for purposes unrelated to religious activities." The court of appeals affirmed on the Tax Court's opinion (Pet. App. 1a).

1. The decision below correctly upheld the Commissioner's revocation of petitioner's tax-exempt status. To qualify for income tax exemption under Section 501(c)(3), a corporation organized for religious purposes must show, among other things, that it was "operated exclusively for religious

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[4]Plans to build this church, however, did not proceed beyond the preliminary drawing stage (Pet. App. 10a).

[5]"R." refers to the separately bound record appendix filed in the court of appeals. "Tr." refers to the trial transcript.

* * * purposes." See *Stevens Bros. Foundation, Inc.* v. *Commissioner*, 324 F. 2d 633 (8th Cir. 1963), cert. denied, 376 U.S. 969 (1964). The term "exclusively" has been interpreted by this Court in a similar context to mean that a single non-exempt purpose, if substantial in nature, will defeat the claim to exemption. *Better Business Bureau* v. *United States*, 326 U.S. 279, 283 (1945).

Here, as the Tax Court correctly observed, "Petitioner's primary, if not sole, activity was the making of passive investments" (Pet. App. 23a). Only five persons were identified as members of the church, and no religious services or functions whatsoever were performed on a group basis. See *Bronner* v. *Commissioner*, 72 T.C. 368 (1979). Indeed, petitioner's only claimed religious activities during these years consisted of "one-to-one" conversations between Slough and his friends and the making of cash gifts to some of them. Such grants made only to Slough's personal friends rather than in an objective and non-discriminatory manner do not constitute an activity in furtherance of an exempt purpose. See *Church in Boston* v. *Commissioner*, 71 T.C. 102, 107 (1978).

2. Section 501(c)(3) of the 1954 Code further provides that an organization is not entitled to a tax exemption if any part of its net earnings "inures to the benefit of any private shareholder or individual." Here, the record discloses an intimate and frequently blurred financial interrelationship between petitioner on the one hand, and Slough and his wholly-owned corporations on the other. The money given to the church never passed out of Slough's control and was used entirely for investment purposes. Slough also occasionally borrowed money from petitioner for his own purposes. Although interest was paid, the loan itself evidences a private benefit to him. *Founding Church of Scientology* v. *United States*, 412 F. 2d 1197, 1202 (Ct. Cl. 1969), cert. denied, 397 U.S. 1009 (1970); *Unitary Mission Church of*

Long Island v. *Commissioner*, 74 T.C. 507, 515 (1980). Additional benefits to Slough and his family are evidenced by petitioner's inadequately explained $1,600 check to Slough's daughter (Pet. App. 27a; compare Tr. 28 with Tr. 106-107), the $5,200 in cash distributions made to his hand-picked recipients, and the purchase of an office building for the use of one of Slough's corporations. Indeed, the Tax Court specifically found that petitioner purchased the building at least in part because of that coporation's need for more office space (Pet. App. 26a). That purpose was plainly not a public benefit.

3. Contrary to petitioner's claims (Pet. 9-22), the decision below does not conflict with *Trinidad* v. *Sagrada Orden*, 263 U.S. 578 (1924). In that case and its progeny (see Pet. 13), it was clear that the organizations in question were operated exclusively for charitable purposes. Consequently, the conduct of an unrelated business "purely incidental to the pursuit of * * * [religious] purposes" (*Trinidad* v. *Sagrada Orden, supra,* 263 U.S. at 581), or the receipt of income from investments unrelated to the organizations' exempt purpose, did not cause the loss of tax exemption. But where, as here, the operation of the business or other unqualifying activity is itself that principal activity of the organization, no exemption from tax is permitted. See *Universal Oil Products Co.* v. *Campbell*, 181 F. 2d 451, 458 (7th Cir. 1950).[6] Thus, the courts below properly relied on *Randall Foundation* v. *Riddell*, 244 F. 2d 803 (9th Cir. 1957), where an organization's extensive stock trading activities

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[6]See also *Parker* v. *Commissioner*, 365 F. 2d 792 (8th Cir. 1966), cert. denied, 385 U.S. 1026 (1967); *People's Educational Camp Society, Inc.* v. *Commissioner*, 331 F. 2d 923 (2d Cir.), cert. denied, 379 U.S. 839 (1964); *Scripture Press Foundation* v. *United States*, 285 F. 2d 800 (Ct. Cl. 1961), cert. denied, 368 U.S. 985 (1962); *Leon A. Beeghly Fund* v. *Commissioner*, 35 T.C. 490 (1960), aff'd on other grounds, 310 F. 2d 756 (6th Cir. 1962).

resulted in the loss of tax exemption even though all the income and assets of the organization were, as here, earmarked for charitable endeavors. As the court noted, "a corporation * * * does not become a charity simply by announcing that it intends to devote the profits to charity" (244 F. 2d at 808).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

FEBRUARY 1981

DOJ-1981-02